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IN THE
Supreme Court of the United States
OCTOBER TERM, 1983

JAMES S. GARVEY, SHIRLEY F. GARVEY, WILLARD W.
GARVEY, JEAN K. GARVEY, GEORGE A. LINCOLN, OLIVIA
G. LINCOLN, H. BERNERD FINK, and RUTH G. FINK,
Petitioners,

v.

UNITED STATES OF AMERICA,
Respondent.

**PETITION FOR A WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE FEDERAL CIRCUIT**

ERWIN N. GRISWOLD
(Counsel of Record)

MICHAEL C. DURST

JONES, DAY, REAVIS & POGUE
655 15th Street, N.W., Suite 600
Washington, D.C. 20005-5701
(202) 879-3898

ROBERT L. HOWARD

MARK G. AYESH

FOULSTON, SIEFKIN, POWERS
& EBERHARDT

700 Fourth Financial Center
Wichita, Kansas 67202

Counsel for the Petitioners

QUESTION PRESENTED

Whether the court of appeals has properly determined that this Court's holding in *Burnet v. Logan*, 283 U.S. 404, no longer applies to purchases of private annuities.

PARTIES

All parties are named in the caption.*

* In addition to the question presented in this petition, the proceedings below involved claims by several corporate plaintiffs under the consolidated return provisions of I.R.C. § 1502 and the interest deduction provisions of I.R.C. § 163. These claims are not raised in this petition, and the corporate plaintiffs below therefore are no longer parties to this action.



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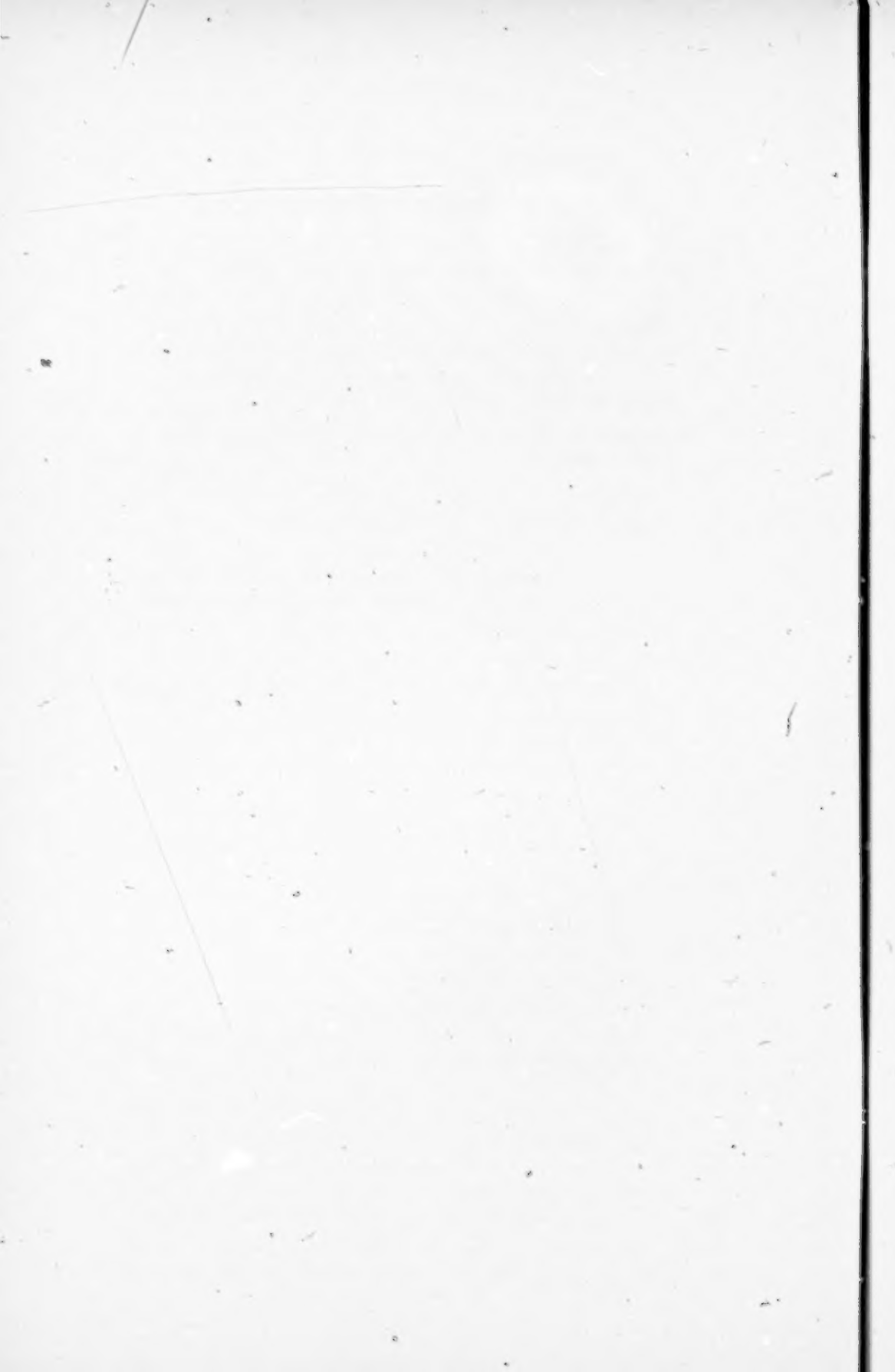
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GARVEY, JEAN K. GARVEY, GEORGE A. LINCOLN, OLIVIA
G. LINCOLN, H. BERNERD FINK, and RUTH G. FINK,
Petitioners,

v.

UNITED STATES OF AMERICA,
Respondent.

**PETITION FOR A WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE FEDERAL CIRCUIT**

Petitioners pray that a writ of certiorari issue to review a judgment of the United States Court of Appeals for the Federal Circuit in four companion civil cases involving the parties named in the caption, who are listed above pursuant to Rule 19.4.

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Federal Circuit is reported at 726 F.2d 1569; it is reprinted as Appendix A, *infra*, pp. 1a-10a. The opinion of the United States Claims Court is reported at 1 Cl. Ct. 108; it is reprinted as Appendix B, *infra*, pp. 11a-52a.

JURISDICTION

The decision of the court of appeals was entered on February 7, 1984. On April 27, 1984, the Chief Justice entered an order extending the time for filing this petition to May 28, 1984. Jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTES INVOLVED

Subsections (a), (b), and (c) of section 72 of the Internal Revenue Code are reprinted as Appendix E, *infra*, pp. 55a-57a.

STATEMENT

The facts are not in dispute. On June 1, 1969, each petitioner transferred property to one of several corporations, in exchange for the corporation's promise to pay a specified sum, annually, for the balance of the transferor's life. In each instance, the value of the property transferred exceeded its "adjusted basis," for tax purposes, in the hands of the transferor. The amount of each annual annuity payment was determined by applying the value of the property transferred to certain standard statistical mortality tables which are set forth in section 20.2031-7(f) of the Treasury Regulations.¹

None of the corporations responsible for making the annuity payments has at any time been in the business of selling annuities to the public. None of the annuity payments has at any time been secured, directly or indirectly, by assets owned by any of the payors. Thus, each annuitant is an unsecured creditor.

Payments under the annuity contracts commenced on August 1, 1970. Initially, the annuitants reported the payments pursuant to the position stated by the Internal Revenue Service in Rev. Rul. 69-74, 1969-1 C.B. 43. Under this ruling, a taxpayer is deemed to realize taxable

¹ The value and tax basis of the property transferred by each annuitant, and the amount of the annuity payment received annually in each case, are set forth in the opinion of the Claims Court at p. 34a, *infra*.

"gain" on the transfer of appreciated property in return for a private annuity, based on the difference between the "present value" of the annuity payments expected to be received and the adjusted tax basis of the property transferred. The taxpayer is required to recognize this gain before he has recovered his basis; the aggregate potential gain is taxed ratably, beginning with the first payment received under the annuity contract. By following the Service's ruling, the petitioners commenced reporting "capital gain" beginning with their first annuity payments.

Subsequently, however, the petitioners filed timely claims for refund, based on this Court's holding in *Burnet v. Logan*, 283 U.S. 404, as well as the opinions of numerous federal courts (including the Tax Court and its predecessor, the Board of Tax Appeals)² which have applied *Burnet v. Logan* in cases of private annuities. Petitioners contended that no one of them could properly be considered as having realized gain until he had first recovered his tax basis in the property which he had transferred. The Internal Revenue Service denied the claims for refund, and the petitioners filed timely suits in the United States Court of Claims.²

Proceedings Below

The Claims Court did not dispute petitioners' arguments that the annuities which they had purchased were unsecured. Nevertheless, the court held that *Burnet v. Logan* no longer applies to purchases of private annuities. The court stated that this Court's holding in *Logan* had been "severely limited" by the later decision in *United States v. Davis*, 370 U.S. 65, which deals with the

² Jurisdiction was based on 28 U.S.C. § 1346(a), now amended by the Federal Courts Improvement Act of 1982, Pub. L. 97-164, § 129, 96 Stat. 25, 39. Pursuant to §§ 402 and 403 of the 1982 Act, 96 Stat. at 57-58, the actions below were transferred to the United States Claims Court on October 1, 1982.

valuation of property for purposes of computing gain in certain circumstances. (App. 40a-41a.) The court also said that Congress had implicitly reversed the traditional application of *Logan* by its enactment of section 72 of the Internal Revenue Code of 1954. (App. 41a-44a.) The court accordingly upheld the contention of the I.R.S. that gain could be recognized beginning with the first annuity payment.

On appeal to the United States Court of Appeals for the Federal Circuit, the petitioners argued that section 72 of the Code deals only with taxation of the "interest" element derived from the investment of amounts paid for an annuity, and that it does not address taxation of the gain realized where appreciated property is transferred for an annuity. Petitioners argued further that the Claims Court had wrongly invoked *United States v. Davis*, since that case deals with the question of how gain shall be measured, *after* it has been *fully* received, and does not deal with the question, involved in *Burnet v. Logan*, of *when* gain shall be recognized when its ultimate receipt is uncertain.

The court of appeals nevertheless affirmed the Claims Court's decision. The court of appeals acknowledged petitioners' argument that section 72, by its terms, did not overturn the traditional application of *Burnet v. Logan* to private annuities. Indeed, the court said, "The real problem is that the statute dealing with taxation of annuities is *silent* as to how to treat the gain element of appreciated property." (App. 6a-7a; footnote omitted, emphasis added.) Nevertheless, the court determined that a congressional reversal of prior precedent could be inferred. The court of appeals did not refer to petitioners' citations to the legislative history of section 72. Similarly, the court did not respond to petitioners' argument that the Claims Court had based its decision upon an improper application of this Court's holding in *United States v. Davis*.

REASONS FOR GRANTING THE WRIT

I. The Courts Below Have Failed to Follow the Applicable Decision of This Court in *Burnet v. Logan*

This case does not involve any question as to *whether* capital gain should be taxed. The only issue here is *when* it is taxable, specifically whether it can be appropriately taxed *before* it has been "realized," and before the taxpayer has recovered his cost basis.

To understand the problem, and its significance, it is necessary to summarize the history of this area of the tax law. This shows that a question which was determined by this Court many years ago, and which has been applied in practice by the lower courts and by the Treasury, has been overturned by the Treasury, without warrant, and that this action has now been approved by the courts below. This abandonment and unwarranted rewriting of a significant doctrine in the tax law merits review by this Court.

(a) *The Question Was Settled by This Court's Decision in Burnet v. Logan, and This Was Firmly Established By Decisions of the Lower Courts and Rulings of the Treasury*

Even before ratification of the Sixteenth Amendment, this Court established the principle that "income" is not derived from the sale of property until the seller has recovered the amount invested in the property sold. In the basic case of *Doyle v. Mitchell Bros.*, 247 U.S. 179,³ the Court upheld the right of a lumber company to deduct the cost of certain timber which it had purchased, in computing its income from the sale of lumber. The Court said (247 U.S. at 185) :

³ *Doyle v. Mitchell Bros.* involved a tax imposed under the Corporation Excise Tax Act of 1909, ch. 6, § 38, 36 Stat. 11, 112-17.

In order to determine whether there has been gain or loss, and the amount of the gain, if any, we must withdraw from the gross proceeds an amount sufficient to restore the capital value that existed at the commencement of the period under consideration.

In *Burnet v. Logan*, 283 U.S. 404, this Court applied its holding in *Doyle v. Mitchell Bros.* to a sale of appreciated property, where payment for the property was contingent on future events and was to be received over an indefinite period of time. The taxpayer in *Logan* had conveyed to a steel company certain shares of stock which carried with them the right to receive a portion of the production of an iron mine. The taxpayer received a cash payment, and also a promise to pay a royalty on all iron ore thereafter produced by the company from the mine. The Commissioner determined that the exchange constituted a "closed" transaction, with gain computed as the amount of the cash received, plus the Commissioner's estimate of the present fair market value of the royalty interest, less the basis of the property transferred.

The Board of Tax Appeals affirmed the Commissioner's determination. 12 B.T.A. 586 (1928). The Court of Appeals for the Second Circuit held, however, that since it was impossible to determine with reasonable certainty the market value of the royalty interest transferred, the transaction remained "open" and the taxpayer should not be required to recognize gain until she had been permitted to recover the basis of the property transferred. 42 F.2d 193 (2d Cir. 1930).

This Court upheld the court of appeals. The Court said (283 U.S. at 413; emphasis supplied) :

The promise was in no proper sense equivalent to cash. It had no ascertainable fair market value. The transaction was not a closed one. Respondent might never recoup her capital investment from payments only conditionally promised. . . . *She properly demanded the return of her capital investment*

before assessment of any taxable profit based on conjecture.

Logan involved royalty payments, rather than an annuity. But the situation with respect to an unsecured private annuity is not appreciably different. No one can tell with accuracy how long this particular annuitant will live, nor can any one forecast with certainty the future solvency of the obligor. Lower tribunals promptly and consistently applied this Court's holding in *Logan* to situations involving the transfer of appreciated property for unsecured private annuities. Thus, in *Lloyd v. Commissioner*, 33 B.T.A. 903, *nonacq.*, XV-2 C.B. 39 (1936), *nonacq. withdrawn and acq. substituted*, 1950-2 C.B. 3, the Board of Tax Appeals rejected the Commissioner's determination that the exchange of appreciated stock for a private annuity constituted a "closed" transaction.

During the tax years in question in *Lloyd*, the revenue laws contained no predecessor to today's section 72, which provides special rules for the taxation of the interest element in annuity payments.⁴ In 1934, however, the Congress enacted special provisions for annuities which later were codified as Section 22(b)(2) of the Internal Revenue Code of 1939. Revenue Act of 1934, ch. 227, § 22(b)(2), 48 Stat. 680, 687.⁵

⁴ Prior to 1934, annuitants were allowed tax-free receipt of all payments until the sum of the payments received was equal to the cost of the annuity. All subsequent payments were included in gross income. See generally B. Bittker, *Federal Income Taxation of Income, Estates & Gifts* ¶ 12.3.1 (1981); Magill & de Kosmian, *The Internal Revenue Code of 1954: Income, Deductions, Gains and Losses*, 68 Harv. L. Rev. 201, 210 (1954).

⁵ Section 22(b)(2) provided:

(2) ANNUITIES, ETC.— . . . Amounts received as an annuity under an annuity or endowment contract shall be included in gross income; except that there shall be excluded from gross income the excess of the amount received in the taxable year over an amount equal to 3 per centum of the aggre-

Following this change in the statute in 1934, the courts continued to apply the rule of *Lloyd* that capital gain on the purchase of a private annuity (as opposed to the "interest" element in each annuity payment) was not subject to taxation until the taxpayer had recovered his investment in the property transferred. The Board of Tax Appeals, and then the Tax Court, confirmed the holding in *Lloyd* under the new statutory regime, first in *Deering v. Commissioner*, 40 B.T.A. 984 (1939), *nonacq.*, 1940-1 C.B. 6, *acq. on annuity issue*, 1950-2 C.B. 2, and then in *Hommel v. Commissioner*, 7 T.C. 992 (1946), *nonacq.*, 1947-1 C.B. 5, *nonacq. withdrawn and acq. substituted*, 1950-2 C.B. 3. A federal district court reached a similar result in *Hill's Estate v. Maloney*, 58 F. Supp. 164, 171-75 (D.N.J. 1944). See also *Evans v. Rothenbies*, 114 F.2d 958 (2d Cir. 1940) (court applied *Logan* where taxpayer claimed loss on purchase of annuity). By 1949, when the United States Court of Appeals for the Third Circuit reached a similar result in *Commissioner v. Kann's Estate*, 174 F.2d 357 (3d Cir. 1949), the applicability of *Burnet v. Logan* was felt by the court to be beyond question. In explaining its holding, the court said simply, "Like the Tax Court we think that there is little to be gained by giving up the principle, now well established, that an agreement by an individual to pay a life annuity to another has no 'fair market value' for purpose of computing capital gain." 174 F.2d at 359 (emphasis added).

After 1949, the Internal Revenue Service accepted the position that the purchase of a private annuity constitutes an "open" transaction, with no gain being taxable until basis has been recovered. First, in 1950 (as indi-

gate premiums or consideration paid for such annuity (whether or not paid during such year), until the aggregate amount excluded from gross income under this chapter or prior income tax laws in respect of such annuity equals the aggregate premiums or consideration paid for such annuity.

cated above), the I.R.S. acquiesced in the holdings in *Lloyd, Deering, and Hommel*. 1950-2 C.B. at 2-3. Then, in Rev. Rul. 239, 1953-2 C.B. 53, the Service formally adopted the holdings of *Lloyd* and *Kann's Estate* as its own. The Service held explicitly that until the sum of the payments received under a private annuity contract (with the exception of the 3% "interest element" subject to taxation under the 1939 Code) equaled the adjusted basis of the property which had been transferred for the annuity, the payments would constitute a tax-free return of capital. After recovery of basis, the portion of each annuity payment which had previously been treated as a tax-free return of capital would be treated as capital gain, until the sum of the payments treated as recovery of capital and as capital gain reached the fair market value of the property originally transferred. After that time, all additional payments under the annuity contract would be treated as payments in excess of the cost of the property transferred and would, under the rules generally applicable to annuities under the 1939 Code, constitute ordinary income. Thus, at the time of enactment of the 1954 Code, no one, including the Service, seriously disputed that the purchase of an unsecured private annuity was an open transaction under the rule of *Burnet v. Logan*.

(b) *There Is Nothing in Section 72 Which Changes This Rule*

In 1954, Congress replaced section 22(b) (2) with section 72 of the current Code, but, as explained in detail at pp. 13-16 below, Congress made clear that it did *not* intend to reverse *Burnet v. Logan* as it applies to private annuities. The new rules retain from the 1939 Code the basic approach of separating the "interest" portion of each annuity payment from the portion which represents a return of the amount paid for the annuity. However, the statute sets up a different mechanism for accomplish-

ing this result. First, the statute designates a portion of each annuity payment as an "excluded" amount. This is the amount which bears the same ratio (called the "exclusion ratio") to each annuity payment as the "investment in the contract" (defined generally as the amount of premiums or other consideration paid for the contract) bears to the "expected return" under the contract (defined as the total of all payments expected to be received over the life of the contract, based on life-expectancy tables maintained by the Treasury). Thus, like section 22(b)(2) of the 1939 Code, section 72 establishes a comprehensive system for taxing the *interest* element earned on annuities, but, as acknowledged by the court of appeals below, section 72 is silent on the taxation of any *gain* realized where a private annuity is purchased in exchange for appreciated property. *There is nothing in section 72 which determines when any portion of this "excluded amount" shall be taxed.*

In keeping with the congressional focus on the "interest" element in annuity payments, articles on private annuities subsequent to the enactment of the 1954 Code continued to describe the taxation of the annuitant with reference to *Logan*, *Lloyd*, *Kann's Estate*, and similar precedent. *See, e.g., Ekman, Private Annuities*, 22 Ohio St. L.J. 279, 282-83 (1961); Cohen, *Recent Developments in the Taxation of Private Annuities*, 16 S. Cal. Tax Inst. 491, 492-98 (1964); Mancina, *The Private Annuity*, 43 Taxes 255, 258-59 (1965); Middleditch, *The Private Annuity: A Way to Cut Estate Costs, Defer Gain and Get Annuity Tax Benefits*, 24 J. Tax'n 160 (1966); Note, *The Use of Annuities in Retirement and Estate Planning*, 53 Iowa L.J. 925, 943 (1968). One writer expressed concern that the *factual* distinction between "private" and "secured" annuities had not been well defined. *See, Ekman, supra*, 22 Ohio St. L.J. at 283. Nevertheless, the commentators appear to have been unanimous that the

enactment of the 1954 Code did not affect the applicability of *Burnet v. Logan*.⁶

(c) *The Treasury Undertakes to Overrule Burnet v. Logan*

Notwithstanding the 1954 Code's silence on the time for taxing capital gain in connection with private annuities, the Service in 1969 abandoned the "open transaction" doctrine as applied to private annuities, and issued Rev. Rul. 69-74, 1969-1 C.B. 43, which the Service asserts against petitioners in the current action. According to Rev. Rul. 69-74, the annuitant's "gain" on the purchase of a private annuity is computed as the difference between the present value of the payments expected to be received under the contract (based on annuity valuation tables contained in the estate tax regulations) and the adjusted basis of the property transferred for the annuity. In defiance of the existing case law, however, the ruling stated that this "gain" is to be taxed ratably over the expected life of the annuity contract, beginning with the *first* payment, and before the basis has been recovered. There is nothing in section 72 which requires or authorizes this provision that the capital gain shall be taxed *before* any capital gain has actually been received.

In issuing Rev. Rul. 69-74, the Service made no effort to explain its wholesale departure from prior case law, as well as from its own holding in Rev. Rul. 239. The Service said simply, "Revenue Ruling 239, C.B. 1953-2, 53, which was issued under different provisions of prior law, is not determinative under section 72(b) of the Code." 1969-1 C.B. at 44. The Service did not address the legislative history of the 1954 Code, or explain the

⁶ One 1968 article refers to the law in this area as "unsettled." Fair, McKinster & Zisman, *The Private Annuity*, 40 Colo. L. Rev. 338, 355-57 (1968). The authors were concerned about future Service policy, but they expressed agreement with other authors who had assumed that the enactment of the 1954 Code worked no change in the treatment of the "gain" element of private annuities. 40 Colo. L. Rev. at 355.

manner in which enactment of the Code affected the applicability of this Court's holding in *Logan*. The Service did not address the more fundamental questions, involving the definition of "income" under the Sixteenth Amendment, which to date have been controlled by this Court's holdings in *Logan*, and in *Doyle v. Mitchell Bros.* Nor did the Service consider the effect that the constitutional question should have on the construction or application of section 72 of the Code.

Revenue Ruling 69-74 has been controversial since its release. One commentary, for example, states:

Revenue Ruling 69-74 violates prior court decisions and even the Service's own former position regarding the income taxation of private annuities. While this prior law existed under the 1939 Code, it had been thought to apply equally to the 1954 Code. The congressional intent behind section 72 of the 1954 Code would call for the application of this prior law to the existing statute, not its inapplicability as decreed in Revenue Ruling 69-74.

Note, *Private Annuities: Rev. Rul. 69-74—Its Significance, Effect, and Validity*, 23 Vand. L. Rev. 675, 693-94 (1970) (footnotes omitted). The commentary concludes that Rev. Rul. 69-74 cannot be reconciled with the holdings in *Logan*, *Lloyd*, and *Kann*, and is therefore invalid. *Id.*, 23 Vand. L. Rev. at 696-97; see also Hodges & Panarisi, *Planning Private Annuities*, 4 Rev. Tax'n of Individuals 214, 217 (1980) ("Revenue Ruling 69-74 represented a significant—and highly questionable—departure in I.R.S. thinking regarding the recognition of gain"); see generally Johnson, *Latest Developments in the Tax Treatment of Private Annuity Transactions*, 14 Tex. L. Rev. 1395, 1405-06 (1969); Ellis, *Private Annuities*, #195-2nd Tax Mgmt. (BNA), Estates, Gifts & Trusts, A9-A12 (1972 & Supp. 1984).

Since 1969, the application of the "open transaction" doctrine to private annuities has been raised in two important Tax Court cases. *Estate of Bell v. Commissioner*,

60 T.C. 469 (1973); *212 Corp. v. Commissioner*, 70 T.C. 688 (1978). In each case, however, the Tax Court avoided the "open transaction" doctrine by finding, on factual grounds, that the annuities in question were "secured" and therefore outside the rule of *Burnet v. Logan*. In both cases, dissenting opinions, joined by large minorities, vigorously criticized the majorities for failing to address the fundamental issues of taxation which were posed. *Estate of Bell*, 60 T.C. at 476-80 (Simpson, J., dissenting, joined by Drennen, Dawson, Tannenwald, Hall, and Wiles, JJ.); *212 Corp.*, 70 T.C. at 804-810, 810-814 (separate dissents filed by Fay, J., and by Simpson, J., joined by Dawson, Wiles, and Wilbur, JJ.). See also *LaFargue v. Commissioner*, 689 F.2d 845, 847 n.3 (9th Cir. 1982); *Fehrs Finance Co. v. Commissioner*, 487 F.2d 184, 189-90 (8th Cir. 1973), *cert. denied*, 416 U.S. 938.

Unlike *Bell* and *212 Corp.*, the current case presents no factual question, and the applicability of *Burnet v. Logan* is directly presented. The court of appeals for the Federal Circuit has decided the issue in conflict with virtually every judicial authority which bears on the question in issue. Moreover, the opinion of the court of appeals threatens to work a wholesale repudiation of the "open transaction" doctrine, without appropriate judicial examination. The confusion which the courts below, and the I.R.S., have created should now be settled authoritatively by this Court.

II. The Legislative History and the Language Actually Used by Congress Provide No Basis for The Action of The Courts Below in Reversing *Burnet v. Logan*

(a) Legislative History

The opinion below creates the impression that the reversal of *Burnet v. Logan* follows naturally from congressional enactment of section 72 of the 1954 Code. In

truth, however, Congress indicated plainly that it did not intend to reverse *Logan*.

As originally passed by the House, the 1954 Code contained, in addition to Section 72, the following provision:

SEC. 1241. EXCHANGE OF PROPERTY FOR AN ANNUITY CONTRACT.

(a) Treatment of Seller of the Property.—

(1) If a taxpayer exchanges property (other than money) for a consideration which includes an annuity contract, the value of the annuity contract computed without regard to the financial condition of the obligor shall be included in the amount realized on such exchange. Such value shall be deemed the amount of premium and other consideration paid for purposes of section 72 (relating to annuities).

H.R. 8300, 83d Cong., 2d Sess. (March 9, 1954).

The House Ways & Means Committee Report explicitly described this provision as a "reversal" of *Burnet v. Logan*. The Committee said:

Subsection (a) (1) provides that the taxpayer who sells or exchanges property under such an arrangement must include in the amount realized on the sale or exchange the value of the annuity contract. The seller of the property shall treat as proceeds from the sale of a capital asset, in the year of sale, any excess of the amount realized including the value of the annuity over the basis of the property given up in the sale or exchange. *This is a reversal of various court decisions including Burnet v. Logan (233 U.S. 404 (1931))*.

H.R. Rep. No. 1337, 83d Cong., 2d Sess. A286 (1954) (emphasis added), reprinted in 1954 U.S. Code Cong. & Ad. News 4017, 4428.

The Senate Finance Committee, however, deleted the proposed section 1241 in its version of the 1954 Code. The Committee said:


The bill as passed by the House, but not your committee's bill, formulated specific rules for the tax treatment of private annuities.

Your committee has not adopted this portion of the House bill.

S. Rep. No. 1622, 83d Cong., 2d Sess. 116 (1954) (emphasis added), *reprinted in* 1954 U.S. Code Cong. & Ad. News 4621, 4749. In conference, the House receded from its position and accepted the Senate version. H.R. Rep. No. 2543, 83d Cong., 2d Sess. 71 (1954), *reprinted in* 1954 U.S. Code Cong. & Ad. News 5280, 5332.

Not many years prior to the Service's adoption of Rev. Rul. 69-74, Congress again considered reversing *Burnet v. Logan* as it applies to private annuities, and again declined to do so. In 1963, the Kennedy Administration proposed legislation to impose a capital gain tax on the gift of appreciated property. The Administration was concerned that taxpayers would use private annuity arrangements as a means of avoiding the new tax, and therefore also proposed legislation similar to that considered in 1954. The Administration acknowledged that its proposal would work a change in existing law. The President's Tax Message said:

Under present law, taxpayers may sell or exchange appreciated property for a private annuity and realize no gain on the sale or exchange, on the theory that the value of the private annuity cannot be ascertained. Since this arrangement would be likely to receive increased use in order to avoid the capital gain tax on transfers of appreciated property, it is appropriate *to change present law* by providing that the sale or exchange will be taxed. The approach to be taken would be, in general, to value the private annuity received as if it were a commercial one.



Tax Recommendations of the President Contained in His Message Transmitted to the Congress January 24, 1963: Hearings Before the House Committee on Ways & Means, 83d Cong., 1st Sess. 140 (1963) (text of President's message submitted to the Ways & Means Committee by Treasury Secretary Dillon on Feb. 6, 1963; emphasis added). The proposal was defeated in committee and never introduced as a bill. See Johnson, *Latest Developments in the Tax Treatment of Private Annuity Transactions*, 47 Tex. L. Rev. 1395, 1405 n.48 (1969).

In light of this history, the action of the Service in adopting Rev. Rul. 69-74 represents simple defiance of Congress.⁷ Although petitioners brought this legislative history to the attention of the court of appeals, the court ignored it. This was a serious omission by the court below, and should be corrected by this Court. The Court of Appeals for the Federal Circuit is one of the leading tax courts in the judicial system. Taxpayers, in planning complicated transactions such as those involving private annuities, should legitimately be permitted to rely on legislative history stated as plainly as that set forth above. In the interests of orderly administration of the tax system, this departure from the congressional mandate should not be permitted to stand.

(b) Language Used by Congress in the Statute

Quite apart from the legislative history, the language used by Congress in section 72 does not justify the conclusion reached by the court below. The court overlooked the opening words in section 72 which, though providing for the inclusion in gross income of "any amount received as an annuity," does so after a clear exclusionary phrase. Section 72(a) begins: "Except as otherwise pro-

⁷ One commentary explains: "It seems apparent that the I.R.S. became frustrated with the legislative process and attempted to nullify the open transaction doctrine by ruling." Hodges & Panarisi, *supra*, 4 Rev. Tax'n of Individuals at 218.

vided in this chapter,” “[T]his chapter” is Chapter 1, entitled “Normal Taxes and Surtaxes,” and it includes all of the material in the Code beginning with section 1 and running through section 1399. Thus, “this chapter” embraces section 1001, which provides in section 1001(a) for taxes on “[t]he gain from the sale or other disposition of property,” and provides that this gain shall be the excess of “the amount realized” over the adjusted basis. It is further provided in section 1001(b) that “the amount realized” from the sale shall be “the sum of any money received plus the *fair market value* of the property (other than money) received.” (Emphasis supplied.)

In this case, the gain involved is that on the transfers of property from the taxpayers to the corporations in exchange for private unsecured annuities. These annuities are just the sort of property with indefinite and unascertainable value to which *Burnet v. Logan* applies. *Burnet v. Logan* is an authoritative construction by this Court of the words “fair market value” which are the same words as those used by Congress in section 1001 of the Code. Thus, Congress, by using the words “fair market value,” made it plain that the amount receivable under a private unsecured annuity shall not be included in “gross income” in section 72(a) until the taxpayer’s basis has been recovered.

Even if it be said that the Treasury has provided to the contrary in Rev. Rul. 69-74, and in section 1.1011-2(c) of the Income Tax Regulations (as amended by T.D. 7207, 1972-2 Cum. Bull. 106, 165), the Government’s case is not helped because this regulation goes beyond the terms of the statute,⁸ as construed by this Court in *Burnet v. Logan*. The Treasury has never been author-

⁸ Indeed, this regulation is not applicable in this case since it applies only to annuity contracts obtained from charitable organizations. Moreover, by its terms (section 1.1011-2(d) of the regulation), it applies only to sales and exchanges made after December 19, 1969, which was after June 1, 1969, the date on which the annuity contracts involved here were written.

ized to "write off" decisions of this Court. *Cf. United States v. Mason*, 412 U.S. 391, 396, where this Court expressed its "difficulty in comprehending how decisions by lower courts can ever undermine the authority of a decision of this Court."

III. The Decisions Below Misrepresent This Court's Holding in *United States v. Davis*

In *United States v. Davis*, 370 U.S. 65, this Court considered the tax consequences of a transfer by a husband of appreciated stock, in return for his wife's release of her marital rights. The Court determined that although the value of the release could not be determined precisely, it was reasonable to assume that the husband and wife had negotiated at arms' length, and that the value of the rights released approximated that of the stock transferred.

The Claims Court has now held that this Court's holding in *United States v. Davis* "severely limited" its prior holding in *Burnet v. Logan*. 1 Cl. Ct. at 123. This assertion is unwarranted. The portion of *Davis* cited by the court below dealt not with the question *whether* gain had been realized, but instead addressed the question *how the benefit actually received in full* was to be valued. See especially 370 U.S. at 71. There was no "open" transaction of any sort, and thus the "open transaction" doctrine was in no way involved. Far from "severely limiting" *Burnet v. Logan*, the Court's opinion in *Davis* does not even mention that case.

In contrast to the opinion of the Claims Court in this case, the Tax Court's recent opinion in *Estate of Wiggins v. Commissioner*, 72 T.C. 701 (1979), illustrates the proper distinction between *Logan* and *Davis*. In *Wiggins*, a taxpayer sold lots in a real estate development on an installment basis. Although the payments were secured by the property transferred, the taxpayer did not perform a traditional credit check on any of the purchasers, and

the prospect that a particular purchaser would actually meet his payment obligation was highly speculative. The court held that under *Burnet v. Logan*, the lot sales constituted "open transactions," and gain could not be recognized until a purchaser's payments exceeded the transferor's basis in the property transferred.

The Tax Court rejected the Commissioner's attempt to confuse the holdings of *Davis* and *Logan*. The court said:

Respondent's assertion that we may infer from the fact that the lots were being sold that the contracts for deed have value is correct as far as it goes. See *United States v. Davis*, 370 U.S. 65 (1962); *Philadelphia Park Amusement Co. v. United States*, 130 Ct. Cl. 163, 126 F. Supp. 184 (1954). However, we are not holding that the contracts were valueless; we simply conclude that it was impossible to determine with fair certainty the market value of the contracts for deed as of the date of sale under the traditional definition of fair market value.

72 T.C. at 713-14 (footnote omitted).

The Claims Court's use of *Davis* in this case serves only to conceal an insupportable reversal of *Burnet v. Logan*. The treatment below of *Davis* and *Logan* seriously distorts two important and entirely distinct doctrines of this Court in the field of federal taxation. This Court should intervene, to ensure that the proper relationship between *Davis* and *Logan*, as explained by the Tax Court in *Wiggins*, is restored.

CONCLUSION

A writ of certiorari to review the judgment and opinion of the Court of Appeals for the Federal Circuit should be granted.

Respectfully submitted,

ERWIN N. GRISWOLD
(Counsel of Record)

MICHAEL C. DURST
JONES, DAY, REAVIS & POGUE
655 15th Street, N.W., Suite 600
Washington, D.C. 20005-5701
(202) 879-3898

ROBERT L. HOWARD
MARK G. AYESH
FOULSTON, SIEFKIN, POWERS
& EBERHARDT
700 Fourth Financial Center
Wichita, Kansas 67202

Counsel for the Petitioners

May, 1984.

APPENDICES

APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE FEDERAL CIRCUIT

No. 83-780

GARVEY, INC., *et al.*,
Appellants
v.

UNITED STATES OF AMERICA,
Appellee

February 7, 1984

Before MARKEY, *Chief Judge*, DAVIS and SMITH,
Circuit Judges.

SMITH, *Circuit Judge.*

In this corporate/individual tax case appellants (Garvey, *et al.*) appeal from a judgment of the United States Claims Court dismissing their petitions for recovery of certain corporate taxes paid as a result of filing consolidated returns; certain individual taxes paid on income received under an unsecured private annuity contract; and corporate taxes paid on the computed interest portion of the annuity payments. We affirm on all substantive issues.

Issues

The major corporate tax issue is whether the investment account adjustment provision¹ of the consolidated

¹ Treas. Reg. § 1.1502-32(b)(2)(iii)(b), T.D. 6909, 1967-1, C.B. 240, promulgated pursuant to § 1502 of the Internal Revenue Code of 1954 (I.R.C. or the code) (26 U.S.C.). (Hereinafter all statutory

return regulations was valid as applied to the Garvey² affiliated corporations which had a low carryover basis resulting from a pre-affiliation stock-for-stock ("B") reorganization.³ Subsidiary issues concern: whether, assuming the Commissioner of Internal Revenue (Commissioner) did correctly apply the regulation, he is nevertheless estopped from enforcing it against Garvey; and whether a variance⁴ exists in the corporate tax issue. The major individual tax question is whether the annuitant-Garveys may recover their respective bases before recognizing gain resulting from the transfer of appreciated property as consideration for an unsecured private annuity contract, as contended by taxpayers, or whether, as the Government asserts, the Garveys must report the gain ratably with their bases.⁵ A further issue is whether the corporate obligor on the annuity contract is entitled to deduct the computed interest portion of the annuity payments.⁶

Background

The facts material to this appeal are as follows:⁷ from 1966 to 1972 the Garvey group of affiliated corporations filed consolidated tax returns. During this time one of

references are to the Internal Revenue Code of 1954 as amended and in effect during the taxable year in issue.)

² "Garvey" will be used in this opinion to refer to corporate or individual appellants as is evident from context.

³ See I.R.C. §§ 368(a)(1)(B) and 362(b) regarding, respectively, "B" reorganizations and carryover basis.

⁴ See I.R.C. § 7422(a); Treas. Reg. § 301.6402-2 (1978).

⁵ See I.R.C. § 72.

⁶ See I.R.C. § 163.

⁷ A complete statement of the facts is contained in the decision below by Judge Miller. *Cf. Garvey, Inc. v. United States*, 1 Cl. Ct. 108 (Cl. Ct. 1983). The pertinent statutes and regulations are set forth there in full or in part, and are not fully repeated here.

the affiliated corporations twice distributed stock as dividends to other affiliated corporations in an amount totaling over \$4.9 million. Because these distributions were made from earnings and profits accumulated *prior* to affiliation, the investment adjustment provisions of the consolidated return regulations⁸ required Garvey to reduce the distributing corporation's stock basis by the same amount. The stock basis in this case was the original shareholders' low \$0.25 million carried over as a result of the corporation's having been brought into the Garvey group in a stock-for-stock ("B") reorganization. Subtracting the \$4.9 million in distributions from a basis of only \$0.25 million resulted in a sizable negative adjusted figure. When the Garvey group disaffiliated in 1972, the Commissioner claimed the resultant figure as an "excess loss account"⁹ which produced a deficiency of nearly \$1.4 million in corporate income tax. Garvey, however, protested the negative adjustment and resulting tax liability for the reasons summarized below, paid the tax, filed a timely claim for refund, and sued for recovery.

Meanwhile, in 1969, the Garvey individuals transferred appreciated property to one or another of the Garvey corporations in exchange for the corporation's unsecured promise to pay the transferor a stated sum annually for the remainder of the transferor/annuitant's life. The amount of the annual payment was determined by dividing the independently appraised value of the property by the appropriate life expectancy factor, including an assumed interest rate of 3.5 percent. The Commissioner asserts that each annual annuity payment consists of three parts: return of basis, capital gain, and ordinary

⁸ See note 1, *supra*. The purpose of such an adjustment is to prevent tax avoidance through the use of consolidated returns to shelter pre-affiliation earnings and profits. *Garvey*, 1 Cl. Ct. at 110-15.

⁹ See Treas. Reg. § 1.1592-32(e)(1), T.D. 6909, 1967-1, C.B. 240, set forth in *Garvey*, 1 Cl. Ct. at 111.

income, to be taxed accordingly. The Garveys claim that they should not have to recognize and pay tax on the property's gain until they first shall have recovered their bases. Hence an issue of *when*, not *whether*, to recognize the gain in the appreciated property arose, *i.e.*, before or after recovery of basis. The corporate obligors on the annuities also claimed the right to deduct on their returns the 3.5 percent assumed interest element included in each annuity payment. All Garvey individual taxpayers paid the deficiencies attributed to the annuity payments, filed timely claims for refund, and sued for recovery.

Discussion

The parties stipulated below all facts regarding these issues; this court therefore faces questions of law which it has analyzed independently.

The Affiliated Corporations

Garvey contends that the Government's strict and literal interpretation of Treas. Reg. § 1.1502-32(b)(2)(iii)-(b) unfairly penalizes Garvey by creating "phantom" income which would not have been taxed had the Garvey group filed separate returns. The tax-avoidance objective of the consolidated return adjustment rules makes sense where the bases of affiliated corporations include pre-affiliation earnings and profits, Garvey contends, but not where such bases exclude such earlier gain, as has occurred in Garvey's case because of its prior "B" reorganization. While Garvey legitimately points out an incongruity in the across-the-board application of this regulation, in asking for an exception Garvey is in effect asking the Commissioner to ignore his statutory mandate to require carryover basis in stock-for-stock reorganizations. This the Commissioner cannot do, and Garvey is caught between the rock and hard spot of electing the benefits of consolidated returns, with the concomitant disadvantage of paying tax upon an excess loss account at dis-

affiliation, or opting for continued separate return status. As Judge Philip Miller has succinctly noted, "the affiliated group that voluntarily elects to file a consolidated return 'must now take the bitter with the sweet.'" *Garvey, Inc. v. United States*, 1 Cl. Ct. 108, 116 (Cl. Ct. 1983), citing *Georgia-Pacific Corp. v. Commissioner*, 63 T.C. 790, 802 (1975). For the reasons correctly and more fully set forth in the opinion below, we affirm the Claims Court on this issue.

Garvey also argues that the Commissioner is estopped from literal application of Treas. Reg. § 1-1502.32(b)(2)-(iii)(b) because in 1968 and 1971 the Treasury Department published proposals to amend the regulation to create an exception in the Garvey-type situation. During this period the existing investment adjustment regulations, which had been published in final form in 1966, were in effect. We agree with the lower court that Garvey's estoppel argument cannot prevail over *existing* regulations, and that its distribution of nearly \$5 million in dividends in the hope that the *proposed* regulations would be adopted was nothing more than that—a hope.¹⁰

Finally, the court below found a variance in Garvey's section 243 dividend taxation argument¹¹ because it at-

¹⁰ Garvey draws this court's attention to a recent Tax Court case, *Elkins v. Commissioner*, 81 T.C. 669 (1983), in which that court held that a taxpayer rightly relied on a reasonable interpretation of a term in a proposed regulation which was subsequently retroactively applied, and that the Commissioner could not fairly sustain his retroactive application of that proposed regulation as regarded the scope of the ambiguous term, in a manner broader than a taxpayer reasonably could have expected when the regulation was proposed. Unlike the case at bar, *Elkins* falls squarely in that category of cases discussed by Judge Miller in which there exists the "reasonably justifiable conduct" necessary to create an estoppel. *Garvey*, 1 Cl. Ct. at 118.

¹¹ See *Garvey*, 1 Cl. Ct. at 116-18. A variance is a prohibited discrepancy between the claim raised before the Treasury and the claim raised in court. *Id.* at 117; note 4, *supra*.

tacked the validity of the investment adjustment rules *generally* rather than their application to Garvey's particular carryover basis situation. Garvey's counsel in oral argument before this court stressed that Garvey rests on its briefs, which attack Treas. Reg. § 1.1502-32(b)(2)(iii)(b) as specifically interpreted and applied against Garvey, and counsel for the United States has conceded that Garvey's attack extends no further. Hence, no variance exists.¹²

The Individuals

Regarding their unsecured private annuity income, the Garveys (annuitants) contend that they should not have to recognize gain on that income until they have recovered their bases in the appreciated property constituting their investment in the annuity contract. The Garveys base their position on a two-step argument: first, that the numerator of the "exclusion ratio"¹³ should be the fair market value and not the adjusted basis of the property, and second, that the unsecured annuity constitutes an "open" rather than "closed" transaction in which no one knows or can reasonably speculate at the time of the transaction (nor until the annuitants die) the amount that will be realized.

The Garveys' emphasis on the "exclusion ratio" issue is misplaced, for regardless of whether the numerator of that ratio is the transferred property's fair market value or its adjusted basis, the Commissioner may calculate taxation of the gain ratably either way.¹⁴ The real prob-

¹² We therefore have considered Garvey's § 243 argument, as has Judge Miller, and find it unpersuasive as regards Garvey's attack on the interpretation and application of Treas. Reg. § 1.1502-32(b)(2)(iii)(b). *Garvey*, 1 Cl. Ct. at 116.

¹³ See § 72(b), set forth at *Garvey*, 1 Cl. Ct. at 121.

¹⁴ Judge Miller has correctly discussed this below. *Id.* Moreover, two cases which the Garveys have cited in support of this argument, *Estate of Bell v. Commissioner*, 60 T.C. 469 (1973), and 212

lem is that the statute dealing with taxation of annuities (I.R.C. § 72) is silent as to how to treat the gain element of appreciated property.¹⁵ Consequently, we turn to the provisions on realization and recognition of gain, section 1001 of the code, for guidance:

Sec. 1001. Determination of amount of and recognition of gain or loss.

(a) Computation of gain or loss

The gain from the sale or other disposition of property shall be the excess of the *amount realized* therefrom over the adjusted basis * * *.

(b) Amount realized

The *amount realized* from the sale or other disposition of property shall be the sum of any money received plus the *fair market value* of the property (other than money) received. * * *

(c) Recognition of gain or loss

Except as otherwise provided in this subtitle, the entire amount of the gain * * * on the sale or exchange of property shall be *recognized*. [Emphasis supplied.]

In the instant case the Garveys have disposed of appreciated property, on which independent appraisers set a fair market value, in exchange for an annuity contract

Corp. v. Commissioner, 70 T.C. 788 (1978), are actually adverse. While in both the Tax Court found that the numerator of the exclusion ratio is indeed the fair market value, the court then proceeded to tax the realized gain "up front"—i.e., the year of the annuity transaction. Both of these cases concerned secured, closed transactions, and in each six judges dissented. See *Garvey*, 1 Cl. Ct. at 125-26.

¹⁵ See § 72(c)(1)(A), set forth in *Garvey* at 121, defining the "investment in the [annuity] contract" as the "consideration paid" for the contract. This does not address the specific problem of appreciated property used as the consideration paid.

consisting of a corporation's unsecured promise to pay the annuitant a set annual sum for the rest of the annuitant's life. The amount of the annual sum has been carefully calculated in relation to each annuitant's life expectancy and the property's fair market value.¹⁶ Does this piece of property, the unsecured annuity contract, which the Garvey annuitant is promised, have an ascertainable fair market value such that section 1001 is called into play, or is its value so speculative and contingent upon unknown future events (*e.g.*, the obligor's solvency, the annuitant's lifetime) that we must "wait and see" before we realize and recognize gain?

The Garveys argue that the Government must "wait and see" on the basis of *Burnet v. Logan*, 283 U.S. 404 (1931), in which the Supreme Court found that a steel company's obligation to pay Mrs. Logan a set amount per ton of ore mined, in consideration of certain stock, was so contingent upon unpredictable future events that no value could be assigned it and Mrs. Logan's gain could not be deemed realized and recognized, until she had in fact recovered her basis in the stock.¹⁷ In other words, the transaction was open, not closed, just as the Garveys argue here.¹⁸ The government counters and the Claims Court has agreed, that in the annuity context, where Congress has enacted a prorated scheme for taxation of income, the open transaction doctrine is at least displaced.

¹⁶ See table setting forth basic figures, *Garvey*, 1 Cl. Ct. at 120.

¹⁷ After she had recovered her basis, Mrs. Logan would receive ordinary income, since this was well before the tax law differentiated between capital gain and ordinary income. *Garvey*, 1 Cl. Ct. at 122. By contrast, the Garveys here consent to taxation of part of their annual annuity payments as ordinary income pursuant to § 72 —*i.e.*, the difference between the gross payment and the exclusion ratio.

¹⁸ The Garveys also emphasize that they, like Mrs. Logan, are cash basis taxpayers, such that the taxpayer must actually *receive* the property in a cash equivalent form before any gain can be realized. See §§ 451(a), 1001-(b).

We find the latter argument persuasive and affirm the opinion below. Granted, a tension exists for cash basis taxpayers such as the Garveys in the interplay between the statutory annuity taxation scheme (section 72) and the statutory principles for realization and recognition of gain (section 1001), where uncertainties such as life expectancies and the obligor's ability to pay cause the ascertaining of a property's fair market value to constitute no more than a statistically intelligent guess. In enacting section 72, however, Congress has shown that it favors predictability of tax liability for the individual over precision in determining gain, based on the rational expectation that over time and throughout the aggregate taxpaying populace individual inequities will average out and the general revenue will be protected.¹⁹ This may little console the Garveys, but, as we have seen in the consolidated return issue above, the tax code constitutes an intricate, intertwined, and not always perfectly balanced mechanism.²⁰

The Interest Deduction

Finally, the Garveys contend that the corporate obligors on their annuity contracts are entitled to deduct, pursuant to section 163, the computed interest portion of the annuity payments. This portion derives from the standard statistical table used to calculate the amount of consideration transferred to the annuitant, which table

¹⁹ See Judge Miller's excellent discussion of the legislative intent and history of § 72. *Garvey*, 1 Cl. Ct. at 123-25. We also note, as has Judge Miller, that since in the years at issue the Garveys have not died before nor outlived their life expectancies, we need not address their unconstitutionality argument. *Id.* at 126.

²⁰ *Burnet v. Logan*, 283 U.S. 404 (1931), also involved an additional indeterminable quantitative factor not present in the instant case—i.e., the number of tons of ore underlying the value of the consideration paid for Mrs. Logan's annuity. Admittedly there are fairly reliable ways of estimating the quantity of ore in a mineral deposit, but it is not likely that the dismal accuracy of actuaries in predicting the collective mortality of mere humans will ever be applied to provide any such mineral estimate on a rational basis.

includes an assumption that the fund or asset would be able to earn 3.5 percent interest during the annuity period. The Government counters that the obligor on a private annuity, granted in exchange for property, makes payments which are both capital in nature and contingent on the annuitant's life span, such that no fixed debt exists upon which "interest on indebtedness" could be deducted pursuant to section 163. The Government also cites section 483(f) of the Internal Revenue Code, providing an exception for annuities to a general provision allowing treatment as interest for some portions of deferred payments made on an exchange of property. The Claims Court has considered these arguments and held, with the weight of most authority, that the deduction is not allowed. We likewise have reviewed this matter and, for the reasons set forth in the Claims Court opinion,²¹ affirm.

Conclusion

Having considered anew all of appellants' contentions set forth before this court, we find them insufficient in merit to warrant reversal of the judgment below.

AFFIRMED

²¹ *Garvey*, 1 Cl. Ct. at 126-28.

APPENDIX B

UNITED STATES CLAIMS COURT

Nos. 389-79T to 393-79T, 395-79T
and 396-79T

GARVEY, INC., *et al.*,

Plaintiffs

v.

UNITED STATES OF AMERICA,

Defendant

January 21, 1983

PHILIP R. MILLER, Judge:

The corporate and individual plaintiffs in these consolidated cases filed suit to recover an aggregate of \$3,447,102 in federal income taxes paid for 1969 through 1977. The cases present issues relating to consolidated return regulations and private annuities. The facts on all issues have been stipulated and insofar as pertinent are stated in the opinion.

I

*The Adjustment To Basis Of The
Subsidiary Corporation's Stock*

On January 4, 1966, an affiliated group of corporations was formed with Garvey, Inc. (Garvey) as the common

parent.¹ Outside this group was another parent-subsidary chain: Petroleum, Inc. (Petroleum) and its wholly owned subsidiary, Lincoln Grain, Inc. (Lincoln). On January 5, 1966, Garvey acquired from Petroleum all of the outstanding Lincoln stock in exchange for 14 percent of Garvey's own stock, thereby bringing Lincoln into the affiliated group. Immediately before this exchange, the basis of the Lincoln stock in the hands of Petroleum was \$2,436,073.

Two years later, on March 28, 1968, Garvey issued 10,404,000 shares of its common stock to the Petroleum shareholders in exchange for 100 percent of the Petroleum stock.² This transaction brought Petroleum into the affiliated group and produced reciprocal stock ownership: Garvey owned 100 percent of Petroleum, which in turn owned 14 percent of Garvey. As of the date of the exchange, Petroleum had accumulated earnings and profits of \$4,700,000, but the Petroleum shareholders had a collective basis in their Petroleum stock of only \$249,602. Because the Petroleum stock was acquired by Garvey in an exchange of stock constituting a reorganization under § 368(a)(1)(B) of the Internal Revenue Code of 1954 (I.R.C. or the Code) (26 U.S.C.)³, pursuant to I.R.C. § 362(b)⁴ Garvey took a carryover basis of \$249,602 as its basis for its Petroleum stock.

¹ This company is not one of the corporate plaintiffs herein. Rather, plaintiff Garvey, Inc. was formed in 1972 as a result of a reorganization involving the affiliated group. As used herein, the term "Garvey" applies to the 1966 parent corporation.

² At the time of this exchange, the shareholders of Petroleum included the same persons who owned Garvey, but the proportion of stock held by each person in each corporation was not the same.

³ Hereinafter and unless otherwise specified, all statutory references are to the Internal Revenue Code of 1954 as amended and in effect during the taxable year in issue.

⁴ I.R.C. § 362(b) provides:

Transfers to Corporations.—If property was acquired by a corporation in connection with a reorganization to which this

The affiliated group filed consolidated tax returns beginning with the 1966 tax year. Subsequently, the members of the group engaged in several transactions which give rise to the issues in dispute. Specifically, on November 19, 1968, Petroleum distributed its Garvey stock (14 percent) as a dividend to Garvey. The amount of this distribution was \$2,426,073, and the distribution was made from Petroleum's preaffiliation earnings and profits, i.e., the earnings and profits accumulated by Petroleum before it became a member of the Garvey group. On August 1, 1970, Garvey contributed all of its Petroleum stock to three of its other wholly owned subsidiaries. On September 22, 1971, Petroleum redeemed this stock from two of the subsidiaries for \$2,551,000 (\$1,445,961 in cash and the remainder in property). It is stipulated that these redemptions constituted dividend distributions and that these distributions also were made from Petroleum's preaffiliation earnings and profits.

I.R.C. § 1502 provides:

Regulations

The Secretary or his delegate shall prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income-tax liability and the various factors necessary for the determination

part applies, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer. This subsection shall not apply if the property acquired consists of stock or securities in a corporation a party to the reorganization, unless acquired by the issuance of stock or securities of the transferee as the consideration in whole or in part for the transfer.

of such liability, and in order to prevent avoidance of such tax liability.

The consolidated return Treasury Regulations promulgated by the Secretary pursuant to I.R.C. § 1502 provide the tax consequences of the above-described distributions by Petroleum. Regulations which deal with investment adjustments, and particularly Treas.Reg. § 1.1502-32, T.D. 6909, 1967-1 C.B. 240, provide in pertinent part as follows:

Investment Adjustment

(a) *In general.* As of the end of each consolidated return year, each member owning stock in a subsidiary shall adjust the basis of such stock in the manner prescribed in this section. * * * The amount of such adjustment shall be the difference between the positive adjustment described in paragraph (b) (1) or (c) (1) of this section, whichever is applicable, and the negative adjustment described in paragraph (b) (2) or (c) (2) of this section, whichever is applicable. Such difference is referred to in this section as the "net positive adjustment" or the "net negative adjustment", as the case may be.

(b) *Stock which is not limited and preferred as to dividends.*—

* * * * *

(2) *Negative adjustment.*—The negative adjustment with respect to a share of stock which is not limited and preferred as to dividends shall be the sum of—

* * * * *

(iii) Distributions made by the subsidiary during the taxable year with respect to such share out of earnings and profits of the subsidiary—

* * * * *

(b) Accumulated in preaffiliation years of the subsidiary.

* * * * *

(e) *Application of adjustment.*—(1) *Net negative adjustment.*—A member owning stock in a subsidiary shall apply its net negative adjustment to reduce its basis for such stock. Any excess of such adjustment over basis is herein referred to as such member's "excess loss account".

Because the distributions from Petroleum were made out of its preaffiliation earnings and profits, the investment adjustment rules required a reduction to the basis of the Petroleum stock by the amount of the distributions. Since that amount exceeded Garvey's basis in the stock, an excess loss account was created. The creation of the excess loss account in itself did not generate any tax liability, for, pursuant to Treas.Reg. § 1.1502-19(a), T.D. 6909, *supra*,⁵ the member's excess loss account is included in income, generally as gain from the sale of stock, only upon the "disposition" of the stock as defined in Treas.Reg. § 1.1502-19(b). In 1972 the group terminated its affiliated status, a transaction considered a "disposition" under Treas.Reg. § 1.1502-19(b)(2)(vi). Accordingly, the members were required to include in their gross income for their taxable year ending March 31, 1972, the excess loss account previously discussed. They failed to do so, however, and the Commissioner on audit included the excess loss account in the group's income. The valid-

⁵ Treas.Reg. § 1.1502-19 provides in pertinent part as follows:

Excess Losses.

(a) *Recognition of income.*—(1) *In General.*—Immediately before the disposition (as defined in paragraph (b) of this section) of stock of a subsidiary, there shall be included in the income of each member disposing of such stock that member's excess loss account (determined under §§ 1.1502-14 and 1.1502-32) with respect to the stock disposed of.

ity of the regulation which requires these adjustments is at issue herein.

The purpose of the investment adjustment regulation is self-evident. Corporations in an affiliated group filing consolidated returns are treated as departments of a single entity. See *American Standard, Inc. v. United States*, 220 Ct.Cl. 411, 418, 602 F.2d 256, 261 (1979). Generally transactions between such corporations in a consolidated return year are given no tax effect, and, in particular, a dividend from one member to the other is not taxable to the recipient. Treas.Reg. § 1.1502-14(a), T.D. 6909, *supra*.⁶ However, it is a basic tenet of the tax law that earnings and profits accumulated when there has been no such affiliation are taxable whenever distributed (see *Commissioner v. Sansome*, 60 F.2d 931 (2d Cir. 1932) and *Commissioner v. Phipps*, 336 U.S. 410, 69 S.Ct. 616, 93 L.Ed. 771 (1949)), and nothing in the statute allowing affiliated groups to file consolidated returns would suggest that Congress intended such returns to be used as a device to insulate from income taxation the distribution of earnings and profits accumulated in preaffiliation years. Accordingly, giving due regard to both principles, the regulations reiterate the scheme of § 1016 of the Code, which provides:

Adjustments to basis

(a) General rule.—Proper adjustment in respect of the property shall in all cases be made—

* * * * *

(4) [I]n the case of stock * * * for the amount of distributions previously made which, under the law

⁶ Treas.Reg. § 1.1502-14 provides in pertinent part as follows:

Stock, Bonds, and Other Obligations of Members.

(a) *Intercompany distributions with respect to stock.*—(1) *Dividends.*—A dividend distributed by one member to another member during a consolidated return year shall be eliminated.

This provision dates back to the consolidated return regulations under the Revenue Act of 1936. Treas.Reg. 97 Art. 31(b).

applicable to the year in which the distribution was made, either were tax-free or were applicable in reduction of basis * * *.

In other words, the regulation states that even if the distribution of preaffiliation earnings and profits from an affiliate corporation to a parent corporation in a consolidated return year was not taxable when received, upon the disposition of the affiliate's stock the parent's basis for the stock is reduced by the amount it has already received free of tax.

The basis adjustment rules seek to achieve the broad objective of preventing tax avoidance that otherwise might occur through the use of the consolidated return. Authority to so regulate was first delegated to the Secretary by § 141(b) of the Revenue Act of 1928, ch. 852, 45 Stat. (part 1) 791, 831, the predecessor to I.R.C. § 1502. The Conference Report that accompanied § 141(b) made clear that Congress expected the Secretary to prescribe regulations dealing with—

[t]he extent to which gain or loss shall be recognized upon the sale by a member of the affiliated group of stock issued by any other member of the affiliated group or upon the dissolution (whether partial or complete) of a member of the group; * * * [and] the extent to which and the manner in which gain or loss is to be recognized, upon the withdrawal of one or more corporations from the group, by reason of transactions occurring during the period of affiliation * * *.

H.R. Rep. No. 1882, 70th Cong., 1st Sess. 16-17, 1939-1 C.B. (part 2) 444, 449. Nothing in subsequent revisions to the 1928 Act indicates any intent to limit the scope of this authority. See *Regal, Inc. v. Commissioner*, 53 T.C. 261, 266 (1969), *aff'd per curiam*, 435 F.2d 922 (2d Cir. 1970).

Treas.Reg. § 1.1502-32(b)(2)(iii)(b) fits squarely within the type contemplated by Congress, for it prevents tax avoidance by fixing the extent to which and the manner in which plaintiff,⁷ upon disaffiliation, is to recognize gain or loss by reason of transactions that took place during the period of affiliation. Such transactions include the dividend distributions that, pursuant to Treas.Reg. § 1.1502-14(a), went untaxed due to the filing of the consolidated tax return. The regulation therefore insures that a distribution that would have been taxable absent the consolidated return does not completely escape taxation through the use of the consolidated return.⁸

Since § 1502 specifically directs the Secretary to prescribe regulations as he may deem necessary in order clearly to reflect the income tax liability of any affiliated group of corporations making a consolidated return both during and after the period of affiliation and to prevent avoidance of such tax liability, such regulations are legislative in character with the force and effect of law, and the Secretary is allowed wider discretion in their promulgation than in the case of merely interpretative regulations. *Union Electric Co. v. United States*, 158 Ct.Cl. 479, 486, 305 F.2d 850, 854 (1962); *American Standard, Inc. v. United States*, *supra*, 220 Ct.Cl. at 416-17, 602 F.2d at 260. However, of course even that discretion is not unlimited.

Plaintiff concedes that "the regulations in this complex area should be sustained unless clearly unreasonable" and that the negative adjustment rules requiring that basis be decreased for distributions out of earnings and profits accumulated by the subsidiary in preaffiliation years of the subsidiary are "logical" and "necessary to prevent

⁷ In this portion of the opinion, the term "plaintiff" refers only to plaintiff Garvey, Inc.

⁸ The consolidated return regulations also convert the income from ordinary income to capital gain. See Treas.Reg. § 1.1502-19(a)(1).

double losses and dividend stripping"⁹—except when the parent's basis for the subsidiary's stock is carried over from the prior stockholders and is less than the fair value of the subsidiary's stock at the time acquired.

Plaintiff says that when a corporation buys all of the stock of another corporation for cash, its cost is generally the value of all of the acquired corporation's property, which consists of the original assets plus the cash and other assets acquired by the subsidiary corporation with its accumulated earnings and profits. If the assets derived from the earnings are then paid out to the parent by way of untaxed dividends, the parent receives back part of its cost, and its remaining cost is attributable only to the subsidiary's remaining assets. Therefore, plaintiff

⁹ A double loss deduction occurs if the loss incurred in a consolidated return year by a subsidiary is used first to offset the taxable income of the group pursuant to Treas.Reg. § 1.1502-12, T.D. 6894, 1966-2 C.B. 362, and again to produce a loss if the subsidiary is sold by the parent corporation for an amount that reflects the loss and is less than the parent's original investment in the subsidiary. For example, Corporation P acquires Corporation S for \$500. In a consolidated return year, P has taxable income of \$300 and S incurs a \$200 loss. Under the consolidated return regulations, the taxable income of the group is \$100 (\$300-\$200). If P then sells S, presumably P could only get \$300 (its original \$500 value minus the \$200 loss). P would then be able to claim a \$200 loss on the sale, thereby utilizing the loss twice. This abuse was prohibited by *Charles Ilfeld Co. v. Hernandez*, 292 U.S. 62, 54 S.Ct. 596, 78 L.Ed. 1127 (1934) and now is codified in the consolidated return regulations. Treas.Reg. §§ 1.1502-19, 1.1502-32.

Dividend stripping is the practice by which a corporation purchases a subsidiary for a price that reflects the subsidiary's accumulated earnings and profits, receives a distribution of those earnings and profits tax-free under Treas.Reg. § 1.1502-14(a) (which eliminates dividend distributions between members of the group), sells the subsidiary for its remaining value and claims a loss. See *Waterman Steamship Corp. v. United States*, 430 F.2d 1185 (5th Cir. 1970), cert. denied, 401 U.S. 939, 91 S.Ct. 936, 28 L.Ed.2d 219 (1971). This abuse also is prohibited by Treas.Reg. §§ 1.1502-19, 1.1502-32.

concedes that it is logical to reduce the parent's basis for the subsidiary's stock by the amount of the untaxed distribution of preaffiliation earnings. However, plaintiff argues, when the parent issues its own stock having equivalent value for all of the stock of the subsidiary, its basis should not be reduced by the distribution of preaffiliation earnings because the parent's basis for its purchase is reduced (by § 362(b)¹⁰) to the subsidiary's former stockholders' basis for their stock and already excludes the value of the subsidiary's accumulated earnings. Therefore, plaintiff contends, if it disposes of the subsidiary's stock for what it paid less the value of the property received as a dividend, the second reduction in basis causes it to be taxed on "phantom gain".

Although the argument is not without superficial appeal, it is meretricious. First, the assertion that the former stockholders' basis for their stock necessarily excludes the value of the subsidiary's accumulated earnings and profits is true only if they were the original stockholders of the subsidiary. It is not accurate if the former stockholders bought their stock from others and some or all of the earnings were accumulated before such purchase.

More important, the reduction in basis for the stock which creates the "phantom gain" is not the reduction required by the regulation but the reduction required by the statute, i.e., § 362(b). This does not depend on there being an affiliated group, consolidated returns and preaffiliation earnings. The following examples serve to illustrate this:

(1) Assume that sole stockholder SH acquired the stock of Corporation S for \$10,000 and that subsequently S accumulated \$10,000 in earnings. If Corporation P then issues to SH P stock having a \$20,000 value in exchange for all of SH's shares, pursuant to I.R.C. § 362(b) P's

¹⁰ See n.4, *supra*.

basis for the S shares remains the same as that of SH, \$10,000. If P then resells the S stock to Y for \$20,000, P has a taxable gain of \$10,000, even though it has received no more than what it paid.

(2) Assume the same initial facts but that after P acquired the S shares S distributes to P the \$10,000 in earnings as a dividend. Since the S assets are thereby depleted, P receives no more than \$10,000 when it resells the S shares to Y. Thus, in such a situation P still has \$10,000 of taxable income, i.e., the dividend from S, even though the sum of the dividend distribution and resale price of the S stock equals no more than what P paid for the stock in the first place.

(3) Assume again the same initial facts but that after P acquired the S shares P and S become an affiliated group, that they file a consolidated income tax return, and that during the consolidated return year S distributes to P as a dividend the \$10,000 in preaffiliation earnings. When thereafter P sells the S shares, because the S assets have been depleted by the dividend P receives no more than \$10,000 for the shares. Under Treas.Reg. § 1.1502-32, P's basis for the S stock is reduced to 0. Therefore, its taxable income is \$10,000, the same as in the previous examples, and the operation of the regulation has not affected that amount.

Prior to the enactment of the predecessors to § 362(b), P's basis for the S stock in Examples (1) and (2) was \$20,000. But Congress became concerned that the reorganization section was being used as a device to deprive the government of its proper taxes by permitting an increased basis for assets and for stock of one corporation acquired by another in exchange for stock in a tax-free reorganization. Therefore, in § 204(a)(7) of the Revenue Act of 1924, ch. 234, 43 Stat. 253, 259, Congress provided that if property is acquired by a corporation in connection with a reorganization by the issuance of its stock and immediately thereafter the transferor or trans-

ferors are in control of the corporation, then the corporation's basis for the property shall remain the same as it would be in the hands of the transferor. The House Ways and Means Committee explained the purpose of the measure:

(2) the provisions of the reorganization section have been rewritten to prevent the use of the section to escape proper taxation by increasing the basis for depreciation or depletion or by increasing the basis for determining gain or loss from the sale of assets transferred in connection with a reorganization or by distributing as capital gains what are in effect dividends out of earnings.¹¹

H.R. Rep. No. 179, 68th Cong., 1st Sess. 7, 1939-1 C.B. (part 2) 241, 246. The Committee also noted as follows:

Under the existing law, if the A Corporation owns assets which cost it \$10,000 but which are now worth \$20,000, it can reorganize into the B Corporation, exchanging shares of stock of the B Corporation for the shares of stock of the A Corporation. Neither Corporation A nor its stockholders realize any taxable gain from the reorganization. The B Corporation, however, can set up the assets received in the reorganization on its books at their market value—that is, \$20,000—and use that amount as the basis for determining the gain or loss from the subsequent sale of the assets and for determining depreciation and depletion. Under paragraph (8) of the draft, however, Corporation B must set up the assets on its books at \$10,000, their basis in the hands of Corporation A, and must use that amount as the basis for determining the gain or loss from the subsequent sale of the assets and for determining depreciation and depletion.

¹¹ The Senate Finance Committee report contains substantially the same language. S.Rep. No. 398, 68th Cong., 1st Sess. at 7, 18, 1939-1 C.B. (part 2) 266, 278-79.

Id. at 17, 1939-1 C.B. (part 2) at 253.

A statement dated March 6, 1924, prepared for the use of the Senate Finance Committee by the Treasury Department, also explained the purpose of the measure:

Section 203 of the bill provides that the gain or loss from exchanges made in connection with the reorganization, whether the exchange is made by the corporation a party to the reorganization or by the stockholders of such corporation, shall not be recognized. The theory underlying the provisions of this section is that the new corporation, that is, the reorganized corporation, is as a matter of fact the same as the old corporation, and that in substance there has been no real change which would result in a realization of profit by the corporations or by their stockholders. The same theory should be applied in determining the basis of the assets transferred in connection with the reorganization. If the new corporation is in substance the same as the old, the basis for determining gain or loss and for depreciation and depletion of the assets of the new corporation should be the same as the basis of those assets in the hands of the old corporation prior to the exchange. The provisions of this paragraph limiting the basis of the assets transferred in connection with the reorganization to the basis in the hands of the transferor represent the logical counterpart of the provisions of section 203 which exempt from tax exchanges made in connection with a reorganization.¹²

Although the 1924 Committee reports indicate that "property" was intended to include stock, in § 113(a) (7) of the Revenue Act of 1928, ch. 852, 45 Stat. 791, 819-20, Congress clarified the 1924 measure to remove any doubt that the carryover of basis requirement applies to a stock

¹² Reprinted in *Seidman's Legislative History of Federal Income Tax Laws: 1938-1861*, p. 704 (J.S. Siedman ed. 1938).

for stock reorganization. See reports of Ways and Means Committee, H.R. Rep. No. 2, 70th Cong., 1st Sess. 18-19, 1939-1 C.B. (part 2) 384, 396-97, and Senate Finance Committee, S.Rep. No. 960, 70th Cong., 1st Sess. 27-28, 1939-1 C.B. (part 2) 409, 427-28. And in 1938 Congress removed the requirement that the transferor of the property or stock retain control over it, in order for the basis to carry over in the reorganization, bringing the statute to the format in which it now reads in § 362(b). Rev. Act of 1938, § 113(a) (7), ch. 289, 52 Stat. 447, 491.

Plaintiff's argument comes down to this: Plaintiff has already suffered a statutory reduction in basis because it acquired the stock of its affiliate in a stock-for-stock non-taxable reorganization. Therefore, although generally it is logical for the regulations to require reduction of the basis of an affiliate's stock for the parent's tax-free receipt of a distribution of its affiliate's earnings in a consolidated return year, plaintiff should be entitled to credit for the prior reduction. But as shown, the purposes of the two reductions in basis are unrelated and may exist independently or concurrently. It seems clear that, although couched in terms of an attack on Treas.Reg. § 1.1502-32, plaintiff's argument really is an effort to nullify the effects of § 362(b), a statute dating back to 1924. The validity of that statute, however, has never seriously been questioned and even plaintiff does not challenge it directly here.

Although, as previously mentioned, plaintiff in its main brief conceded that the provisions of Treas.Reg. § 1.1502-32(b) (2) (iii) (b) requiring a reduction in the basis because of the receipt of an untaxed distribution of pre-affiliation earnings are logical except where the member has a carryover basis in the affiliate's stock, in its reply brief plaintiff urges for the first time that the regulation is at odds with § 243 of the Code. That section allows to a corporation receiving a taxable dividend from another corporation a deduction of 85 percent of the amount of

the dividend. Plaintiff asserts that applying the 48 percent corporate maximum tax rate in effect during 1968-71 to the 15 percent remainder results in a 7.2 percent tax on the dividends, whereas the effect of the regulation's reduction in the basis of the affiliate's stock because of the untaxed dividend was to subject the increased gain on the disposition in 1972 to a 30 percent capital gains tax.

Plaintiff contends that this increased tax violates the principle, enunciated by the Tax Court in *Joseph Weidenhoff, Inc. v. Commissioner*, 32 T.C. 1222, 1242 (1959), that the Secretary has no authority—

to prescribe a regulation which will * * * impose a tax on income that would not otherwise be taxed (by limiting the excess profits credit) simply because the taxpayers exercise the privilege of filing consolidated returns, unless it is to prevent tax avoidance.

But the quotation lays down no principle applicable to consolidated return regulations generally. It was merely an expression of the court's frustration over its inability to understand the purpose of a regulation limiting the excess profits credit of corporations becoming members of an affiliated group after a particular date and the failure of both the regulations and the Commissioner to explain such purpose. Therefore, it said, "in the absence of possible tax avoidance or some necessity for its use to properly determine the tax liability, we do not think [the regulation] can be applied, without explanation, in the absolute discretion of the Commissioner." *Id.*

The obvious purpose of the regulation here at issue, which reduces the plaintiff's basis of its stock in its subsidiary for untaxed dividends from preaffiliation earnings of the subsidiary, is to prevent tax avoidance.

The election to file a consolidated return for an affiliated group inherently carries with it both advantages and

disadvantages as compared to filing separate returns. For example, consolidation offers the opportunity to offset losses of one company against profits of another (see Treas.Reg. § 1.1502-12, T.D. 6894, 1966-2 C.B. 362); deferral of gain on intercompany transactions (see Treas.Reg. § 1.1502-13, T.D. 6894, *supra*); and group use of the foreign tax credit and charitable contribution limitations (see Treas.Reg. § 1.1502-11, T.D. 6894, *supra*). On the other hand, consolidation subjects a member to deferral of its loss deduction on intercompany transactions (see Treas.Reg. § 1.1502-12); adjustments to opening and closing inventories for intercompany profits (see Treas.Reg. § 1.1502-18, T.D. 6894, *supra*); and possible reduction of loss carryover (see Treas.Reg. § 1.1502-21, T.D. 6894, *supra*).¹³ In promulgating consolidated return regulations, the Secretary is not obligated to offer a taxpayer all the benefits of consolidation while simultaneously preserving for it all deductions and benefits of separate returns. As the court stated in *Georgia-Pacific Corp. v. Commissioner*, 63 T.C. 790, 802 (1975), the affiliated group that voluntarily elects to file a consolidated return "must now take the bitter with the sweet."

More important, since the argument based on § 243 challenges the validity of the regulation generally rather than merely its operation as applied to a carryover basis, it is obviously a different claim from the one made earlier in the case and from that made administratively; and defendant has not waived the variance.

I.R.C. § 7422(a) provides that no suit shall be maintained in any court for the recovery of any internal revenue tax alleged to have been collected erroneously until a claim for refund has been filed with the Secretary or his

¹³ That the filing of a consolidated return may cause changes in income tax liability was noted by the Court of Claims in *American Standard, Inc. v. United States*, 220 Ct.Cl. 411, 420 n.6 and 422 n.12, 602 F.2d 256, 262-63 n.6 and 264 n.12 (1979), despite its citation to the *Weidenhoff* opinion.

delegate according to regulations established pursuant to law. The applicable regulation is Treas.Reg. § 301.6402-2 (1978), which in pertinent part provides as follows:

(b) *Grounds set forth in claim.* (1) No refund or credit will be allowed * * * except upon one or more of the grounds set forth in a [timely] claim * * *. The claim must set forth in detail each ground upon which a credit or refund is claimed and facts sufficient to apprise the Commissioner of the exact basis thereof * * *.

The validity of this regulation has been upheld repeatedly. *Angelus Milling Co. v. Commissioner*, 325 U.S. 293, 65 S.Ct. 1162, 89 L.Ed. 1619, *reh'g. denied*, 325 U.S. 895, 65 S.Ct. 1162, 89 L.Ed. 2006 (1945); *Real Estate-Land Title & Trust Co. v. United States*, 309 U.S. 13, 17-18, 60 S.Ct. 371, 373, 84 L.Ed. 542 (1940); *Disabled American Veterans v. United States*, 227 Ct.Cl. 474, 475, 650 F.2d 1178, 1179 (1981); *Forward Communications Corp. v. United States*, 221 Ct.Cl. 582, 623-24, 608 F.2d 485, 508 (1979). In *Union Pacific R.R. v. United States*, 182 Ct. Cl. 103, 108-09, 389 F.2d 437, 442 (1968), the Court of Claims stated:

It is an undisputed general rule that a ground for refund neither specifically raised by, nor comprised within the general language of, a timely formal or informal application for refund to the Internal Revenue Service cannot be considered by a court in which a suit for refund is subsequently initiated. [Citations omitted.] The rule that a taxpayer cannot present one ground for refund in its claim and a different ground in its petition is designed both to prevent surprise and to give adequate notice to the Service of the nature of the claim and the specific facts upon which it is predicated, thereby permitting an administrative investigation and determination. [Citation omitted.] In addition, the Commissioner is provided

with an opportunity to correct any errors, and if disagreement remains, to limit the scope of any ensuing litigation to those issues which have been examined and which he is willing to defend [Citations omitted.]

It is not enough that the government was given an opportunity to respond to the plaintiff's new claim by a supplemental memorandum in this lawsuit. Notice of the particular claim must have been filed with the Internal Revenue Service. *Disabled American Veterans v. United States, supra*; *Union Pacific R.R. v. United States, supra*.

Prior administrative consideration of such a claim is particularly appropriate here. For, even though plaintiff claims the regulation is invalid in its entirety, that would not be the only possible consequence of their argument. Rather, the regulation could be invalid only to the extent that it required a basis reduction greater than that needed to reflect the availability of the 85 percent deduction of § 243. Alternatively, giving effect to § 243 might necessitate allowing the parent the option to include the intercorporate dividend in income at the time received rather than subject itself to the reduction in basis of its affiliate's stock. Perhaps the parent could be given the choice retroactively, or some other equitable adjustment should be made pending promulgation of new regulations. Possibly such an adjustment in favor of the plaintiff equivalent to what it could have had if it had not filed a consolidated return would necessitate its giving up other related benefits in the consolidated return context. If the parent received the dividend free of tax in one year but was entitled to the dividend deduction as an offset to capital gain on the disposition of the affiliate's stock 20 years later, would the government be entitled to a credit because the parent had tax-free use of the funds for so long? Plaintiff has offered no guidelines as to the manner in which the basis should be adjusted to reflect its § 243 argument, nor has it suggested how the excess loss account would be treated upon disposition of the Petroleum

stock. These questions make clear the wisdom of allowing such an issue to be addressed first by the Commissioner rather than by the court, which has not been delegated the responsibility of drafting consolidated return regulations and has only limited flexibility.

Plaintiff also claims that Petroleum made the distributions in reliance on 1968 and 1971 published proposals by the Treasury to amend Treas.Reg. § 1.1502-32, which would have excepted a carryover basis for the stock of an affiliate from reduction of basis for a dividend from pre-affiliation earnings and profits, and, although the proposed amendments were not adopted, the Secretary is now estopped from applying the existing regulations to plaintiff without the aborted amendments, even if they are otherwise valid.

The existing investment adjustment regulations were published in final form in December 1966 and remained in effect and unchanged throughout the years in issue. The 1968 and 1971 distributions by Petroleum, therefore, were made at a time when the regulations, to which plaintiff voluntarily consented, required the adjustments to basis be made at the end of each consolidated return year. Thus, contrary to plaintiff's characterization of the case, the issue herein does not involve retroactive application of a regulation. Rather, the question presented is whether the Secretary should be estopped to apply a regulation in precisely the manner in which it appeared at all relevant times.

The heart of plaintiff's argument is that it was justified in relying on its belief that the proposed amendments would be adopted in final form and that there would be no basis adjustment as a result of the distributions by Petroleum. However, reliance on the possible adoption of proposed amendments is not the reasonably justifiable conduct that is necessary to create an estoppel. As the term itself makes clear, proposed amendments are merely preliminary proposals. They are published in the *Federal*

Register pursuant to the Administrative Procedure Act, 5 U.S.C. § 553, in order to give notice to the public of a proposed regulation that is under consideration. But there is nothing that requires the government to adopt in final form a regulation published as a proposed amendment, particularly when, as here, a valid regulation that deals with the subject already is in effect. Indeed, plaintiff was given actual notice by the preamble in the *Federal Register* that the proposed amendments were only tentative. The 1968 proposal appeared under the following preamble:

Notice is hereby given that the regulations set forth in *tentative* form below are *proposed* to be prescribed by the Commissioner of Internal Revenue * * * (Emphasis supplied.)

33 Fed.Reg. 5878 (1968). The 1971 proposal was published under a nearly identical preamble. See 36 Fed.Reg. 16661 (1971). Furthermore, the Treasury Department did nothing to encourage plaintiff's belief, since the only other Treasury pronouncement regarding the proposed amendments was a technical explanation of the 1971 proposal.

Plaintiff's underlying assumption is that once a proposed amendment is published it is binding on the government and may only be modified or deleted so as to *favor* taxpayers. But it is difficult to comprehend why this should be so. The notice of the proposal is made not only to those adversely affected thereby but to all interested persons—e.g., public interest groups, tax law commentators and academicians, members and staffs of Congressional committees having oversight responsibilities, and other Treasury and Internal Revenue Service personnel. Furthermore, nothing in the notice prevents the promulgators from reconsidering it in the light of pertinent statutes and its adverse effects upon the revenue. See *Georgia-Pacific Corp. v. Commissioner*, *supra*, 63 T.C. at 802-03.

Plaintiff also argues that its reliance upon the adoption of the proposals was warranted and the government should be estopped because 5 years elapsed between the original 1968 proposal and its deletion in 1973. But the dividends at issue were distributed in 1968 and 1970-71, far less than 5 years from the publication of the proposal. Moreover, the elapsed time between the proposal and deletion should have just as logically given rise to precisely the opposite inference—that the Treasury had reason to doubt the wisdom or validity of the proposals and was reconsidering them.

It is stipulated that in structuring its transactions plaintiff was advised by experienced tax counsel familiar with the applicable tax statutes and regulations. In multimillion dollar intercorporate transactions, where there is even the slightest doubt as to the tax consequences, it is customary for experienced tax counsel to request an advance private ruling from the I.R.S., which, if favorable, may ordinarily be relied upon by a taxpayer. *Bornstein v. United States*, 170 Ct.Cl. 576, 345 F.2d 558 (1965). In the absence of other evidence, it may be fairly inferred that plaintiff's decision not to make such a request and to rely on the proposed regulation instead was prompted by the desire not to "rock the boat." In short, plaintiff's conduct in relying on proposed amendments in structuring its transactions falls far short of conduct that merits an estoppel against the government.

Wendland v. Commissioner, 79 T.C. No. 22 (August 23, 1982), relied on by plaintiff, is inapposite. In that case, the taxpayers acquired an ongoing coal mine and at the time of purchase had actual knowledge that the Secretary previously had proposed a regulation which, if adopted, would deny a deduction available to the taxpayers under the then-existing regulation. The taxpayers also knew that the effective date of the proposed regulation was to be retroactive and would predate the purchase of the mine. Nonetheless, the taxpayers purchased the mine and

planned on the deduction. After the acquisition, the proposed regulation was adopted in final form with the retroactive effective date, and the Secretary applied it to the taxpayers to deny their deduction. The Tax Court upheld the Secretary's action. In so doing, the court concluded that taxpayers that have been put on notice that the Secretary *might* promulgate a new regulation could not ignore that possibility when planning their transactions and act in reliance on the old regulation. Application of the *Wendland* decision to the instant case, therefore, would require plaintiff, when it structured the dividend distributions from Petroleum, to have taken into account that the Secretary *might* amend Treas.Reg. § 1.1502-32. But the *Wendland* case has no bearing whatever on the rule that plaintiff seeks to apply in this case, namely, that once the Secretary publishes preliminary views in a proposed amendment he is estopped from withdrawing the proposal.

Gottesman & Co. v. Commissioner, 77 T.C. 1149 (1981), another case relied upon by plaintiff, also is inapposite. In that case, the issue was whether the consolidated group was subject to the accumulated earnings tax, and resolution of the issue depended on the manner of computing the group's accumulated taxable income. The regulations on the subject were ambiguous. On one occasion the Secretary proposed new regulations requiring consolidated calculations. He then withdrew this, and proposed different new regulations requiring separate calculations. In turn he withdrew these and never adopted any regulation on the subject. At trial the Commissioner contended that the taxpayer was required by the preexisting regulations to use consolidated calculations. The court first ruled that the preexisting regulations did not resolve the problem at all. It then ruled that in view of the Secretary's inability to make up his mind, there was an unfilled gap in the regulations. Therefore, the Commissioner's ad hoc interpretation of the old regulation was no more reasonable than the taxpayer's and an in-

sufficient basis for the imposition of an accumulated earnings tax (a penalty tax on excessive accumulations). Here, however, there is no gap to be filled: Treas.Reg. § 1.1502-32(b) (2) (iii) (b) was valid and in effect at the time each distribution was made and plaintiff knew precisely what adjustments to basis it required.

Finally, plaintiff contends that the regulation, which is intended to prevent tax avoidance, should not be applied here because they could have liquidated Petroleum, distributed its assets, and avoided entirely taking the excess loss account into income. Plaintiff states that there can be no tax avoidance here since the government concedes that there was an alternative which would have achieved the desired tax result. But as the Supreme Court stated in another context—

[t]his Court has observed repeatedly that, while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not * * * and may not enjoy the benefit of some other route he might have chosen to follow but did not.

Commissioner v. Nat. Alfalfa Dehydrating, 417 U.S. 134, 149, 94 S.Ct. 2129, 2137, 40 L.Ed.2d 717 (1974). See also *Blitzer v. United States*, 231 Ct.Cl. —, —, 684 F.2d 874, 887 (1982), quoting *Heyman v. Commissioner*, 70 T.C. 482, 487 (1978), *aff'd*, 652 F.2d 598 (6th Cir. 1980) (“We must decide this case, however, on its facts * * * regardless of any assertions as to how things might have been done otherwise”).

Based on the foregoing, judgment on the consolidated return issue must be entered in favor of defendant.

II

*The Income Received By The Individual Plaintiffs From
The Annuity Contracts With The Corporations*

On June 1, 1969, each of the individual plaintiffs (annuitants) transferred property to one or the other of the corporate plaintiffs in exchange for the corporation's unsecured promise to pay to the transferor an annual sum for the life of the annuitant.

The property transferred by each of the annuitants was appraised contemporaneously by independent appraisers. The amount of the annual payment to each annuitant was determined by dividing the appraised value of the property by the appropriate factor set out in a table in Treas.Reg. § 20.2031-(7)(f). This section of the regulations sets forth the present worth of an annuity of one dollar to be paid for the remainder of an individual's life based on a standard statistical mortality table and an assumed rate of interest. The present worth table assumes that each member of the group from which the statistics were derived will have the same mortality experience and that the fund will earn at least the assumed interest rate. The agreed interest rate used to compute the annuities at issue was 3.5 percent.

The property transfers and annuity contracts may be summarized as follows:

Annuitant- Transferor of Property	Transferee Corporation	Basis of Property to Transferor	Fair Market Value of Property Transferred	Annuity
Willard W. Garvey	Garvey Industries	\$2,107,154	\$7,628,231	\$502,416
Jean K. Garvey	Garvey Industries	60,979	222,062	14,020
James S. Garvey	JaGee Corp.	2,881,976	8,457,252	523,358
Shirley F. Garvey	JaGee Corp.	32,304	167,550	10,170
H. Bernard Fink	Mid-West Industries	302,566	1,050,770	92,686
Ruth G. Fink	Mid-West Industries	1,695,143	6,717,185	474,116
George A. Lincoln	Lincoln Industries	64,853	336,369	21,237
Olivia G. Lincoln	Lincoln Industries	1,682,436	6,848,261	400,685

Since the enactment of the Internal Revenue Code of 1954, the tax law has required each annuity payment to

be treated as both the receipt of income and the return of an aliquot portion of the premium paid for it. The entire annuity payment is included in gross income and then the proportion of each annuity payment which the annuitant's investment in the annuity contract bears to his total expected return therefrom is excluded from income. The pertinent Code provisions are found in I.R.C. § 72, which in relevant part provides as follows:

Annuities; Certain proceeds of endowment and life insurance contracts

(a) General rule for annuities.—Except as otherwise provided in this chapter, gross income includes any amount received as an annuity * * * under an annuity * * * contract.

(b) Exclusion ratio.—Gross income does not include that part of any amount received as an annuity under an annuity * * * contract which bears the same ratio to such amount as the investment in the contract (as of the annuity starting date) bears to the expected return under the contract (as of such date). * * *

(c) Definitions.—

(1) Investment in the contract.—For purposes of subsection (b), the investment in the contract as of the annuity starting date is—

(A) the aggregate amount of premiums or other consideration paid for the contract * * *

* * * * *

(3) Expected return.—For purposes of subsection (b), the expected return under the contract shall be determined as follows:

(A) Life expectancy.—If the expected return under the contract, for the period on and after the annuity starting date, depends in whole or in part on the life expectancy of one or more in-

dividuals, the expected return shall be computed with reference to actuarial tables prescribed by the Secretary or his delegate.

The issue herein is: When the investment in the annuity is not in the form of cash but of property valued in excess of what the transferor-annuitant originally paid for it, how is that gain to be reflected in his income?

Defendant has ruled and maintains herein that such gain is likewise realized as an aliquot portion of each annuity payment received: i.e., until the gain is fully reported each annuity consists of three parts—return of basis, capital gain and ordinary income. Rev.Rul. 69-74, 1969-1 C.B. 43 and Treas.Reg. § 1.1011-2(c) (Example 8).

Where the consideration paid for the annuity contract is a cash premium or property, the basis of which is the same as its value, the computation required by I.R.C. § 72(b) for calculating the annual exclusion from income is—

$$\frac{\text{Consideration for the contract}}{\text{Total expected return}} \times \text{Annuity}$$

This is subtracted from the annuity payment to arrive at the portion remaining in income.

However, where the consideration for the annuity contract is property having a value in excess of the transferor's basis, in Rev.Rul. 69-74 the government takes the position that the proper method of calculating the exclusion per annuity requires the substitution of the lower "transferor's basis" for the higher "fair market value" as the consideration for the contract. This results in a larger allocation to income in each annuity. If the property exchanged for the annuity is a capital asset, the ruling arrives at the capital gain component of such annual income by subtracting the basis of the transferred property from the present value of the total expected return

(as of the annuity starting date)¹⁴ and dividing the difference by the remaining years of the annuitant's life expectancy. The ruling subtracts this annual gain from the annuity income. In Treas.Reg. § 1.1011-2(c) (Example 8), which relates to annuity contracts obtained from charitable organizations in exchange for property, the same result is reached without reducing the numerator of the exclusion fraction from market value of the investment to basis, merely by subtracting the prorated annual capital gain (calculated as in Rev.Rul. 69-74) from the annual exclusion rather than from the annual income.¹⁵

Initially the individual plaintiffs reported the annuity receipts on their tax returns pursuant to Rev.Rul. 69-74. Subsequently they filed timely claims for refund asserting that each was entitled to treat the exchange of property for annuities as an "open transaction" in which no gain was realized until the transferor fully recovered the basis of his property. This was based on the conceptions that whether or not a lifetime annuitant would actually have any gain could not be determined at the time of the initial annuity receipts because of the uncertainty as to how long he would live to be entitled to them; and that since none of the obligations was issued by a life insurance company with statutory reserves and none was otherwise secured, the obligor's ability to pay was also too uncertain to give rise to the realization of gain in any annuity receipt prior to recovery of total basis.

Plaintiffs' argument for treating the exchanges of property for life annuities as open transactions is said to be based on the theory underlying *Burnet v. Logan*, 283

¹⁴ The present value of the total expected annuities is determined from the annuity tables in the Treasury regulations at the rate of interest used in the annuity contract.

¹⁵ Neither the ruling nor the regulation spells out the Service's position with respect to property having a basis to the transferor in excess of its value at the time of transfer.

U.S. 404, 51 S.Ct. 550, 75 L.Ed. 1143 (1931). There the taxpayer, Mrs. Logan, had owned, since prior to March 1, 1913, 250 shares of stock in a company owning rights to iron ore. In 1916 she sold such shares to a steel company for a lump sum plus the right to receive 60 cents per ton of iron ore mined over a long term lease without any requirement for production by the company of minimum or maximum tonnage. The Commissioner of Internal Revenue ruled that the obligation of the steel company to pay the taxpayer 60 cents per ton had a fair market value in March 1916; that this sale of stock should be regarded as a closed transaction; and that such 1916 fair market value should be regarded as the basis for future payments derived from the agreement. The Supreme Court disagreed. It decided that because the consideration for the sale of Mrs. Logan's 250 shares included the promise of future money payments wholly contingent upon facts and circumstances not possible to foretell with anything like fair certainty, it had no ascertainable fair market value and the transaction was not a closed one in 1916. Therefore, she had no income from the sale of such shares until the payment she received exceeded their basis (March 1, 1913 value).

The foregoing represents plaintiffs' view of *Burnet v. Logan, supra*. But because plaintiffs in their brief deal with only half the decision it appears that they fail to comprehend its limitations. Mrs. Logan's mother had also owned, since March 1, 1913, 1,100 shares of similar stock, and in 1916 she too sold her stock to the steel company for an identical kind of compensation. Prior to the taxable years at issue, 1917-20, Mrs. Logan's mother died and by will left her right to receive the 60 cents per ton of ore to Mrs. Logan, which the estate valued at \$277,164. Thereafter Mrs. Logan likewise received payments on account of the contract rights she had received from her mother's estate. The Court treated those payments as having a \$277,164 basis because "some kind of valuation [of such contract right]—speculative or otherwise—was

necessary" for estate tax purposes. 283 U.S. at 413-14, 51 S.Ct. at 552-53. The key to the difference in treatment of the two contract rights may be found in the Court's comments with respect to the first that:

We are not dealing with royalties or deductions from gross income because of depletion of mining property. Nor does the situation demand that an effort be made to place according to the best available data some approximate value upon the contract for future payments * * * [as] probably was necessary in order to assess the mother's estate.

Id. at 412, 51 S.Ct. at 552.

It is questionable whether the first part of *Burnet v. Logan* has any bearing on the treatment of gain derived from exchanging appreciated property for an annuity contract. The years at issue in *Burnet v. Logan* were well before the tax law prescribed disparate treatment for capital gains and for ordinary income.¹⁶ The tax law now generally requires an effort wherever possible to separate the gain on the exchange of property for a contract and the ordinary income derived from the latter. Nothing in § 72 provides that such separation should not be made in taxing annuities. Indeed, the section so provides in excluding from ordinary income the aliquot portion attributable to the consideration paid for it. Thus the Code supplies what the Court found to be lacking in the first part of *Burnet v. Logan*, i.e., a "situation demand[ing] that an effort be made to place according to the best available data some approximate value upon the contract for future payments." 283 U.S. at 412, 51 S.Ct. at 552.

In *McCormac v. United States*, 191 Ct.Cl. 483, 424 F.2d 607 (1970), the Court of Claims rejected the same

¹⁶ The first special treatment for capital gains appeared in Section 206(b) of the Revenue Act of 1921, ch. 136, 42 Stat. (part 1) 227, 233.

kind of overly broad application of the "open transaction" rationale of *Burnet v. Logan* which the plaintiffs urge here. There the taxpayers had transferred stock of a cemetery corporation to a non-profit corporation in exchange for an agreement to pay to the transferors 40 percent of the transferee's gross sales (an uncertain amount) for the life of the cemetery (an indefinite period). The taxpayers contended that because of the uncertainty as to how much they would receive the contract could not be fairly valued and the transfer of stock was for the indefinitely continuing payments, which should be treated as return of their investment and, if exceeded, capital gain. However, recognizing the need imposed by law to separate the capital gain on the exchange from the ordinary income derived from the contract, the court approved the position of the Internal Revenue Service in Rev.Rul. 58-402, 1958-2 C.B. 15 that "[c]ontracts and claims to receive indefinite amounts, such as those received in exchange for stock * * * must be valued for Federal income tax purposes *except in rare and extraordinary cases.*" 191 Ct.Cl. at 499, 424 F.2d at 619. (Emphasis the court's.) See also *Campbell v. United States*, 228 Ct.Cl. —, —, 661 F.2d 209, 215 (1981); *Estate of Bird v. United States*, 534 F.2d 1214, 1218 (6th Cir. 1976).

Moreover, if the exchange of appreciated assets for a contract is otherwise a taxable event, the argument that no gain is realized (I.R.C. § 1001(a), (b)) because the property received has no readily ascertainable value, has been severely limited by the rule in *United States v. Davis*, 370 U.S. 65; 82 S.Ct. 1190, 8 L.Ed.2d 335 (1962). Section 1001(a) of the Code provides that the gain from the disposition of property shall be the excess of "the amount realized" therefrom over the adjusted basis for determining gain; and § 1001(b) provides that "the amount realized" shall be the sum of any money received plus "the fair market value of the property (other than money) received." In *Davis*, the taxpayer, in a divorce

settlement, had transferred to his wife various appreciated properties. The "property received" being the release of the wife's inchoate marital rights, the Court of Claims found that there was no way to compute the fair market value of such marital rights and it was thus impossible to determine the taxable gain realized by the taxpayer. The Supreme Court held this conclusion was erroneous because "[A]bsent a readily ascertainable value it is accepted practice where property is exchanged to hold that the values 'of the two properties exchanged in an arms length transaction are either equal in fact, or are presumed to be equal' [citation omitted]." See also *Matthews v. United States*, 191 Ct.Cl. 674, 425 F.2d 738 (1970).

Even if *Burnet v. Logan* continues to provide a viable construction of § 1001 of the Code in some contexts, it should not have any force with respect to the application of § 72. That section provides that a proportionate part of every annuity is includable in income without regard to whether or not the annuitant has or ever will recoup his entire investment¹⁷, and the section is not limited to annuities issued by insurance companies with statutory reserves or to those payable out of designated funds or secured by trusts or mortgages, so that there need be no assurance that the obligor will be able to pay back the

¹⁷ S. Rep. No. 1622, 83d Cong., 2d Sess. 171, reprinted in 1954 U.S. Code Cong. & Ad. News 4621, 4806, states:

(3) In the case of amounts received as an annuity (other than certain employee annuities), the proportionate part of each payment which is to be considered a return of investment (and thus excludable from gross income) is to be determined by the ratio which the investment in the contract bears to the expected return under the contract. The investment in the contract will be determinable from actuarial tables to be provided by the Secretary or his delegate. *Once determined for a particular contract the excludable portion of the payment remains fixed despite the fact that the individual may die before or after his life expectancy.* * * * [Underscoring supplied.]

H.R. Rep. No. 1337, 83d Cong., 2d Sess. A21, reprinted in 1954 U.S. Code Cong. & Ad. News 4017, 4157, is substantially identical.

annuitant's premium or investment before the remainder becomes taxable. Furthermore, the section requires the determination in every case of the cash or fair market value of the consideration paid for it, which under the rule of *United States v. Davis* provides a satisfactory measure of its *quid pro quo*, the commuted value of the annuity payments. Thus, it is evident that Congress can hardly have intended that the operation of § 72 be restricted by the theory of *Burnet v. Logan*.

Since § 72 of the Code prescribes the method of taxation of annuity income, resolution of the question of the proper treatment of the capital gain involved in an exchange of appreciated property for a private annuity contract more properly calls for an examination of the purposes of that statute rather than for speculation as to the proper application of a 50-year old Supreme Court decision interpreting earlier statutes and derived from a wholly different set of circumstances.

Both the House and Senate committee reports on the Internal Revenue Code of 1954 explained that the purpose of § 72(a) through (c) was to revise the method of taxing annuity income under the 1939 Code because it was unsatisfactory. Section 22(b) of the 1939 Code taxed an annuitant on the annuity payments he received to the extent of 3 percent of the amount he paid for the annuity. Any payments he received above that amount were considered to be the return of his capital and were excluded from tax until the cumulative amount excluded equalled the amount he paid for the annuity. Thereafter, the annuity payments he received were taxable in full. The Senate Committee on Finance explained the purpose and operation of the new legislation as follows:

This present [1939] rule is objectionable because it is erratic. Where the amount paid for the annuity represents a large proportion of its value at the time payments begin, the present rule does not return to the annuitant on a tax-free basis the amount he paid for the annuity during his lifetime. On the other hand, where the amount the annuitant paid for the

annuity represents a small proportion of its value at the time payments begin, the exclusion is used up rapidly. In such cases the annuitant finds that after being retired for a few years and becoming accustomed to living on a certain amount of income after tax, he suddenly has to make a sizable downward adjustment in his living standard because, when his exclusion is used up, the annuity income becomes fully taxable.

The House bill and your committee have adopted a provision which spreads the tax-free portion of the annuity income evenly over the annuitant's lifetime. In the usual case the exclusion will equal the amount the annuitant paid for the annuity, divided by his life expectancy at the time the payments begin. This exclusion is to remain the same even though he outlives this life expectancy. Under this rule the company providing the annuity will be able to supply the annuitant with a statement indicating that for the rest of his life a stated amount of his annuity income will be excluded annually from his income subject to tax.¹⁸

S.Rep. No. 1622, 83d Cong., 2d Sess. 11, *reprinted in* 1954 U.S.Code Cong. & Ad. News 4621, 4640-41.

Nothing in the committee reports suggests any purpose to exclude from income the capital gain that would otherwise be payable on an arms length exchange of property for annuities at fair market value where such value is in excess of the transferor's basis for the property. Indeed the committee reports are incompatible with the notion that any sum in excess of basis is to be excluded from income each year the annuity is received. The Senate report states that subsection (b) of § 72 establishes an exclusion ratio "which is designed to exclude from

¹⁸ H.R. Rep. No. 1337, *supra*, at 11, contains substantially identical language.

gross income the proportionate part of each amount received as an annuity which is considered to represent a return of capital." S. Rep. No. 1622, *supra*, at 172, 1954 U.S. Code Cong. & Ad. News 4807.¹⁹ If the exclusion ratio is designed to exclude from income only the part of the annuity which represents "a return of capital," it is necessarily limited to a return of the annuitant's basis for the property exchanged. To allow a taxpayer to exclude from income the portion of an annuity he purchased with untaxed gain would give him far more than a return of capital. *Cf. Detroit Edison Co. v. Commissioner*, 319 U.S. 98, 63 S.Ct. 902, 87 L.Ed. 1286 (1943).

As previously stated, plaintiffs do not dispute that capital gain may be derived from the exchange of appreciated property for an annuity contract but claim that it is not realized until after the transferor has had the amount of his entire basis for the property returned to him free of tax. But plaintiffs' proposal is not consistent with the intent of the current statutory scheme for taxing annuities. If the income on the exchange of property for an annuity contract is to be taxed on the receipt of each annuity, there is no basis in Congressional intent for postponing the tax on a part of such annual receipt. Moreover plaintiffs' proposal would restore the 1939 Code situation where the annuitant would be unable to spread his tax payments evenly over his remaining lifespan and would cause him to incur large tax liability in his later years after the basis of his property has been returned. It is more in keeping with the statutory scheme and, therefore, more reasonable to impute to Congress the intent that the capital gain as well as the ordinary income component of the annuity payments should be prorated over the return of the annuity.²⁰

¹⁹ H.R. Rep. No. 1337, *supra*, at A22, is substantially identical.

²⁰ See Learned Hand, "How Far is a Judge Free in Rendering a Decision?" (Radio Broadcast, May 4, 1933) reprinted in *The Spirit*

In *212 Corporation v. Commissioner*, 70 T.C. 788 (1978) and *Estate of Bell v. Commissioner*, 60 T.C. 469 (1973), the Tax Court ruled that the capital gain on appreciated property exchanged for a secured private lifetime annuity contract was realized when the parties entered into the contract, the measure being the difference between the basis for the transferred property and the value of the annuity contract. Although in both cases the same uncertainties existed as to whether and when the annuitant would recoup his basis, the court was of the opinion that, the obligation under the annuity contract being secured, it was property the receipt of which was in itself a taxable event. In each case six judges dissented, being of the view that § 72 requires the proration of the capital gain as well as the ordinary income. However, the Tax Court's decisions in these cases are not significant precedents with respect to the issue herein, since neither side urges that the receipts of the unsecured annuity contracts in these cases were the taxable events giving rise to capital gain.

There remains for consideration plaintiffs' argument that, if § 72 requires the pro rata reporting in each year of gain on the property exchanged for the annuities irrespective of whether or not the annuitant ever recovers

of Liberty—Papers and Addresses of Learned Hand (I. Dilliard ed. 1960), p. 106:

* * * How does [the judge] in fact proceed? Although at times he says and believes that he is not doing so, what he really does is to take the language before him, whether it be from a statute or from the decision of a former judge, and try to find out what the government, or his predecessor, would have done, if the case before him had been before them. He calls this finding the intent of the statute or of the doctrine. This is often not really true. The men who used the language did not have any intent at all about the case that has come up; it had not occurred to their minds. Strictly speaking, it is impossible to know what they would have said about it, if it had. All they have done is to write down certain words which they mean to apply generally to situations of that kind. * * *

his basis in the property, it is unconstitutional because it taxes gross receipts rather than income. Although plaintiffs do not go so far, it may be noted that the same argument may be made against the validity of the entire annuity taxing scheme—since even an annuitant who acquired his contract for a cash premium may never recover his investment in the contract if he dies before his life expectancy termination date.

However, it is unnecessary to reach the unconstitutionality argument in this case. The record does not reflect that any of the annuitant plaintiffs died prior to the end of his life expectancy and that his estate was denied recovery of his basis in the annuity contract. Both Rev.Rul. 69-74 and Treas.Reg. § 1.1011-2(c) (Example 8) provide that where the transferor-annuitant outlives his life expectancy and therefore has reported in capital gains the entire appreciation on the transferred property the income component of his annuities thereafter is wholly ordinary income; but neither the ruling nor the regulation states the Internal Revenue Service's position with respect to the overpayment by a short-lived annuitant of capital gain tax on appreciated property exchanged for an annuity contract. The proper treatment of such an overpayment was not briefed by either party, and defendant's attorney stated at oral argument that he could not set forth the I.R.S.'s position on it. Although § 72 does not permit a readjustment of the ordinary income component of the annuities of either the short- or long-lived annuitant, it does not deal specifically with the capital gain component. It may be that the estate of a short-lived annuitant would be entitled to a capital loss deduction. Cf. *Arrowsmith v. Commissioner*, 344 U.S. 6, 73 S.Ct. 71, 97 L.Ed. 6 (1952). Or it may be that the estate would be entitled to tax refunds for prior years with the aid of the Mitigation of Effect of Limitations Statutes, I.R.C. §§ 1311-1314. In any event, constitutional issues should not be decided on hypothetical facts and in the absence of full briefing by both sides.

Accordingly, judgment must be granted in favor of defendant on this issue.

III

The Interest Deductions Claimed by the Corporate Plaintiffs

The annuity contracts exchanged for the properties of the individual plaintiffs contained no provisions for interest. However, as previously noted, the amount of consideration transferred was computed from standard tables which set forth the average present worth of an annuity of one dollar to be paid for the remainder of the life of an individual based on a standard statistical mortality table and the assumption that the fund would be able to earn 3.5 percent interest during the interim period. Stemming from this the corporate plaintiffs claim that implicitly included in each annuity payment during the taxable years was a 3.5 percent interest payment and they were entitled to deduct it on their income tax returns pursuant to I.R.C. § 163.²¹

Two barriers stand in the way of the allowance of such a deduction. First, "an expenditure incurred in acquiring capital assets must be capitalized even when the expenditure otherwise might be deemed deductible under [I.R.C.] Part VI [in which § 163 is included]." *Commissioner v. Idaho Power Co.*, 418 U.S. 1, 17, 94 S.Ct. 2757, 2767, 41 L.Ed.2d 535 (1974). Second, the deduction allowed by § 163 is for interest paid or accrued within the taxable year "on indebtedness." No interest deduction is allowable on obligations which are not payable unconditionally but depend upon the occurrence of particular

²¹ I.R.C. § 163 provides in pertinent part as follows:

Interest

(a) General rule.—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

events. *Cuyuna Realty Co. v. United States*, 180 Ct.Cl. 879, 883, 382 F.2d 298, 300 (1967); *Guardian Investment Corp. v. Phinney*, 253 F.2d 326, 331 (5th Cir. 1958); *United States v. Virgin, Jr.*, 230 F.2d 880 (5th Cir. 1956); *Autenreith v. Commissioner*, 115 F.2d 856, 858 (3d Cir. 1940).

Practically all courts which have considered the issue are now in agreement that no part of an annuity payment made pursuant to a private annuity contract for the purchase of property is deductible as interest under § 163. The entire amount of each annuity payment constitutes part of the purchase price of the property, a capital expenditure, and, therefore, no part thereof is deductible as interest. The mere fact that the annuities are paid over a period of time so that the parties must have taken into account the delay in payment as a factor in fixing the amount does not mean that the purchase price is a lesser sum plus interest. Furthermore, when each annuity is contingent upon the continued existence of a measuring life or lives, the obligation is not payable in any event and hence is not an indebtedness for which interest may be deductible pursuant to § 163. *Bell v. Commissioner*, 76 T.C. 232, 237-39 (1981), *aff'd per curiam*, 668 F.2d 448 (8th Cir. 1982); *Dix v. Commissioner*, 392 F.2d 313, 317-18 (4th Cir. 1968); *F.A. Gillespie & Sons Co. v. Commissioner*, 154 F.2d 913, 917-18 (10th Cir.), *cert. denied*, 329 U.S. 781, 67 S.Ct. 204, 91 L.Ed. 670 (1946); *Autenreith v. Commissioner*, *supra*, 115 F.2d at 858; *Klein v. Commissioner*, 31 B.T.A. 910, 917-19 (1934), *aff'd*, 84 F.2d 310 (7th Cir. 1936); *Corbett Investment Co. v. Helvering*, 75 F.2d 525 (D.C. Cir. 1935); *Reliable Incubator & Brooder Co. v. Commissioner*, 6 T.C. 919, 926 (1946).

Plaintiffs cite only a single case to the contrary: *John C. Moore Corp. v. Commissioner*, 15 B.T.A. 1140 (1929), *aff'd*, 42 F.2d 186 (2d Cir. 1930). In that case, on December 26, 1912, the corporate taxpayer had entered into

an agreement with the owner of the premises it leased to pay her \$10,000 per year for life in return for her conveyance of the buildings to it. The question at issue was whether or not the corporation was entitled to deduct the annual payments for the taxable years 1922 and 1923. The Board of Tax Appeals found that as of the contract date the value of the buildings and the discounted value of the annuity contracts were both \$80,000. It ruled that the transaction was an exchange of the buildings for the annuity contract and not for the annuities themselves; therefore, each \$10,000 annual payment consisted in part of satisfaction of the contract liability for the principal and in part of interest, and the amount deductible as interest for each year was the difference between the \$10,000 and its discounted value (at a 6 percent annual rate) as of December 26, 1912. Seven Board members dissented for the reason that "no part of the amounts paid by the corporation to the seller of the building can be deducted, because all payments are the purchase price or cost of the building and such an investment of capital is not deductible." 15-B.T.A. at 1145. The Court of Appeals affirmed, holding that even if the exchange was property for annuities (rather than for the contract), the Board's setting aside of the Commissioner's proposed disallowance of deduction of part of each annuity was still correct, because the parties intended the exchange to be an \$80,000 building for \$80,000 in annuities and any excess payments in 1922 and 1923 were either losses (because \$80,000 had already been paid out) or interest payments. It did not find it necessary to decide which theory was correct.

However, the Board of Tax Appeals and Tax Court in decisions since *Moore Corp.* have repudiated the Board's theory in that case and have followed the rule asserted by the dissent, see e.g., *Klein v. Commissioner*, *supra*; *Citizens National Bank of Kirksville v. Commissioner*, 42 B.T.A. 539, 544-45 (1940), *aff'd*, 122 F.2d 1011 (8th Cir. 1941), *cert. denied*, 315 U.S. 822, 62

S.Ct. 913, 86 L.Ed. 1219 (1942); *Reliable Incubator & Brooder Co. v. Commissioner*, *supra*; *Kaufman's Inc. v. Commissioner*, 28 T.C. 1179, 1184-85 (1957); *Dix v. Commissioner*, 46 T.C. 796, 804 (1966), *aff'd*, 392 F.2d 313, 317-18 (4th Cir. 1968); *Bell v. Commissioner*, *supra*; and, while the Court of Appeals for the Second Circuit has not had occasion to rule on the issue again, as the cases *supra* indicate, its *Moore Corp.* decision is contrary to the decisions of at least six other circuits and the Tax Court.

Plaintiffs urge, as did the court in *Moore Corp.*, that if the law taxes annuity income to the recipient, the rule should be reciprocal and the payor should be allowed a deduction to the same extent. But this is only a superficial equity, which the Code does not require in other contexts. For example, a builder who is paid for the construction of a plant receives ordinary income while the payor has made a non-deductible capital expenditure. A bank charging interest on a construction loan receives ordinary income but the payor may treat the payment as a capital expenditure.²²

Far from adopting plaintiffs' theory that in a contract to acquire property in exchange for annuities there is implicit an agreement that only a portion of each annuity is principal and the remainder is interest, there is evidence that Congress has been aware of the contrary decisions of the courts and has either approved or at least has not disapproved them.

At the time of the adoption of the Internal Revenue Code of 1954, when Congress approved the revised treatment of annuities in § 72, it also had under consideration a proposed § 1241 which provided rules for handling the tax consequences of an exchange of property in return for a series of payments contingent upon the life expectancy of the seller of the property. The proposed section specified that the taxpayer who sells or exchanges

²² I.R.C. § 266.

property under such an arrangement must include in the amount realized on the sale or exchange the value of the annuity contract; and it also provided that the portion of each annuity payment made by the purchaser of the property which is equal to the portion includable in the gross income of the annuitant pursuant to the application of § 72 should be deducted from the gross income of the purchaser as interest. The House Committee explained that "This is * * * a departure from the court decisions, e.g., *Gillespie and Sons v. Comm.* (154 Fed. 913, cert. den. 39 U.S. 781)." ²³ H.R. Rep. No. 1337, *supra* at A287. Since Congress did not enact the proposed § 1241 (because it wanted an opportunity for further study of the operation of § 72), ²⁴ its understanding that in the absence of such measure existing law does not allow deductions for imputed interest is evidence of its continuing intent in this regard.

More important, in 1964 Congress enacted § 483 of the Internal Revenue Code. This section provides that generally, on a sale or exchange of property pursuant to which some of the payments are deferred for more than a year, portions of the deferred payments are to be treated as interest both to seller and buyer. But it also provided as a specific exception in subsection (f) :

(5) Annuities.—This section shall not apply to any amount the liability for which depends in whole or in part on the life expectancy of one or more individuals and which constitutes an amount received as an annuity to which section 72 applies.

Plaintiffs argue that when § 483(f) (5) refers to "an amount received as an annuity to which section 72 applies," it means only that portion which § 72(b) excludes

²³ The citation to *Gillespie and Sons* contains several typographical errors. For the correct citation see p. 127, *supra*.

²⁴ S. Rep. No. 1622, *supra*, at 116; H. Conf. Rep. No. 2543, 83d Cong., 2d Sess. 71, *reprinted in* 1954 U.S. Cong. & Ad. News 5280, 5332.

from income treatment, and therefore imputed interest treatment is still proper for the portion included in the annuitant's gross income. Nothing in the statutory language warrants plaintiffs' reading. Although § 72(b) allocates the annuity between principal and income, the section necessary applies to the entire annuity. The committee reports are also incompatible with plaintiffs' overly restrictive interpretation. The House Committee report on § 483, H.R. Rep. No. 749, 88th Cong., 2d Sess. 74, *reprinted in 1964 U.S. Code Cong. Ad. News 1313, 1382* states:²⁵

[T]he provision is not to apply where the property is exchanged for annuity payments which depend in whole or in part on the life expectancy of one or more individuals.

It is evident that Congress has been aware that the case law denies interest deductions for a taxpayer who makes deferred payments in the form of lifetime annuities in exchanges for property. It has also given consideration to the allowance of such deductions but has declined to do so. Under the circumstances even if I disagreed with the overwhelming weight of authority (which I do not), I must infer that Congress has reserved to itself the making of any changes therein. Plaintiffs' arguments should therefore more properly be addressed to the legislature than to this court. *Cf. American Automobile Association v. United States*, 367 U.S. 687, 694-97, 81 S.Ct. 1727, 1730-32, 6 L.Ed.2d 1109 (1961).

Judgment must likewise be granted in favor of defendant on this issue.

CONCLUSION

For the foregoing reasons judgment should be entered dismissing all petitions. The clerk is directed to allow costs to the defendant.

²⁵ S. Rep. No. 830, 88th Cong., 2d Sess. 103, *reprinted in 1964 U.S. Code Cong. & Ad. News 1673, 1776* contains identical language.

APPENDIX C
IN THE UNITED STATES CLAIMS COURT

Nos. 389-79 T through 393-79 T, 395-79 T,
and 396-79 T

GARVEY, INC., *et al.*

v.

THE UNITED STATES

[Filed Jan. 21, 1983]

JUDGMENT

Pursuant to the Opinion of January 21, 1983, it was held that plaintiffs are not entitled to recover with the complaints to be dismissed.

IT IS ORDERED AND ADJUDGED this date, pursuant to Rule 58, that the complaints are dismissed with costs to the prevailing party.

FRANK T. PEARTREE
Clerk of Court

By: /s/ Debra L. Samler
Deputy Clerk

NOTE: As to appeal, 60 days from this date, see FRAP
4(a)

APPENDIX D

UNITED STATES COURT OF APPEALS
FOR THE FEDERAL CIRCUIT

No. 83-780, 389-79, et al.

GARVEY, INC., et al.,

Appellants,

v.

THE UNITED STATES,

Appellee.

JUDGMENT

On Appeal from the United States Claims Court

This CAUSE having been heard and considered, it is
ORDERED and ADJUDGED: AFFIRMED.

Dated February 7, 1984

ENTERED BY ORDER OF THE COURT
GEORGE E. HUTCHINSON
Clerk

/s/ Dorothy I. Myers
Chief Deputy Clerk

Issued as a Mandate: March 14, 1984

Costs Issued April 17, 1984: Against Appellant.

Printing\$84.48

TOTAL\$84.48

APPENDIX E**Internal Revenue Code Section 72,
Subdivisions (a), (b) and (c)**

(a) **GENERAL RULE FOR ANNUITIES.**—Except as otherwise provided in this chapter, gross income includes any amount received as an annuity (whether for a period certain or during one or more lives) under an annuity, endowment, or life insurance contract.

(b) **EXCLUSION RATIO.**—Gross income does not include that part of any amount received as an annuity under an annuity, endowment, or life insurance contract which bears the same ratio to such amount as the investment in the contract (as of the annuity starting date) bears to the expected return under the contract (as of such date). This subsection shall not apply to any amount to which subsection (d) (1) (relating to certain employee annuities) applies.

(c) **DEFINITIONS.**—

(1) **INVESTMENT IN THE CONTRACT.**—For purposes of subsection (b), the investment in the contract as of the annuity starting date is—

(A) the aggregate amount of premiums or other consideration paid for the contract, minus

(B) the aggregate amount received under the contract before such date, to the extent that such amount was excludable from gross income under this subtitle or prior income tax laws.

(2) **ADJUSTMENT IN INVESTMENT WHERE THERE IS REFUND FEATURE.**—If—

(A) the expected return under the contract depends in whole or in part on the life expectancy of one or more individuals;

(B) the contract provides for payments to be made to a beneficiary (or to the estate of an

annuitant) on or after the death of the annuitant or annuitants; and

(C) such payments are in the nature of a refund of the consideration paid,

then the value (computed without discount for interest) of such payments on the annuity starting date shall be subtracted from the amount determined under paragraph (1). Such value shall be computed in accordance with actuarial tables prescribed by the Secretary. For purposes of this paragraph and of subsection (e) (2) (A), the term "refund of the consideration paid" includes amounts payable after the death of an annuitant by reason of a provision in the contract for a life annuity with minimum period of payments certain, but (if part of the consideration was contributed by an employer) does not include that part of any payment to a beneficiary (or to the estate of the annuitant) which is not attributable to the consideration paid by the employee for the contract as determined under paragraph (1) (A).

(3) EXPECTED RETURN.—For purposes of subsection (b), the expected return under the contract shall be determined as follows:

(A) LIFE EXPECTANCY.—If the expected return under the contract, for the period on and after the annuity starting date, depends in whole or in part on the life expectancy of one or more individuals, the expected return shall be computed with reference to actuarial tables prescribed by the Secretary.

(B) INSTALLMENT PAYMENTS.—If subparagraph (A) does not apply, the expected return is the aggregate of the amounts receivable under the contract as an annuity.

(4) ANNUITY STARTING DATE.—For purposes of this section, the annuity starting date in the case

of any contract is the first day of the first period for which an amount is received as an annuity under the contract; except that if such date was before January 1, 1954, then the annuity starting date is January 1, 1954.

No. 83-1855 (2)

Office - Supreme Court, U.S.

FILED

AUG 9 1984

ALEXANDER L. STEVAS,
CLERK

In the Supreme Court of the United States

OCTOBER TERM, 1984

JAMES S. GARVEY, ET AL., PETITIONERS

v.

UNITED STATES OF AMERICA

*ON PETITION FOR A WRIT OF CERTIORARI TO
THE UNITED STATES COURT OF APPEALS FOR
THE FEDERAL CIRCUIT*

BRIEF FOR THE UNITED STATES IN OPPOSITION

REX E. LEE

Solicitor General

GLENN L. ARCHER, JR.

Assistant Attorney General

ROBERT A. BERNSTEIN

MICHAEL J. ROACH

Attorneys

Department of Justice

Washington, D.C. 20530

(202) 633-2217

BEST AVAILABLE COPY

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QUESTION PRESENTED

Whether the petitioners are entitled to treat the receipt of an unsecured private annuity in exchange for appreciated property as an open transaction under *Burnet v. Logan*, 283 U.S. 404 (1931), thereby deferring recognition of gain resulting from the exchange until they have recovered their basis in the property transferred, or whether they should be required to report the gain ratably as each of the annuity payments is received.



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§ 403, 96 Stat. 57 4

Internal Revenue Code of 1954 (26 U.S.C.):

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Miscellaneous:

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(1954) 8

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In the Supreme Court of the United States

OCTOBER TERM, 1984

No. 83-1855

JAMES S. GARVEY, ET AL., PETITIONERS

v.

UNITED STATES OF AMERICA

*ON PETITION FOR A WRIT OF CERTIORARI TO
THE UNITED STATES COURT OF APPEALS FOR
THE FEDERAL CIRCUIT*

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-10a) is reported at 726 F.2d 1569. The opinion of the Claims Court (Pet. App. 11a-52a) is reported at 1 Cl. Ct. 108.

JURISDICTION

The judgment of the court of appeals (Pet. App. 54a) was entered on February 7, 1984. On April 27, 1984, the Chief Justice extended the time for filing a petition for a writ of certiorari to May 28, 1984. The petition was filed on May 14, 1984. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. On June 1, 1969, each petitioner transferred appreciated property to a corporation in return for the corporation's unsecured promise to pay a life annuity to the transferor (Pet. App. 34a). The amount of each annuity was

(1)

calculated by dividing the fair market value of the property (as independently appraised) by the appropriate life annuity factor prescribed by the Commissioner for valuing annuities for estate and gift tax purposes (Treas. Reg. § 20.2031-7(f)). Pet. App. 34a.¹

Each petitioner reported his or her receipt of annuity payments on tax returns for the years in suit in accordance with the computation contained in Rev. Rul. 74, 1969-1 C. B. 43 (Pet. App. 37a). Under that Revenue Ruling, the full yearly annuity payment is considered gross income and then a portion is excluded from income pursuant to ratios prescribed by Section 72(b) of the Code.² That exclusion ratio is computed by dividing the basis of the transferred property by the total expected return from the annuity contract. This exclusion ratio is then multiplied by the annuity payment to obtain the annual exclusion under Section 72. The capital gain on the transfer of the property in exchange for the annuity is recognized ratably over the annuitant's life expectancy as given by the expected return

¹The annuities paid to each of the petitioners were as follows (Pet. App. 34a):

Annuitant (age)	Basis of Property Transferred	Fair Market Value on June 1, 1969	Annuity Factor	Annuity
Willard W. Garvey (49)	\$2,107,154	\$7,628,231	15.1831	\$502,416
Jean K. Garvey (47)	60,979	222,062	15.8388	14,020
James S. Garvey (46)	2,881,976	8,457,252	16.1596	523,358
Shirley F. Garvey (45)	32,304	167,550	16.4754	10,170
H. Bernerd Fink (60)	302,566	1,050,770	11.3369	92,686
Ruth G. Fink (52)	1,695,143	6,717,185	14.1678	474,116
George A. Lincoln (47)	64,853	336,369	15.8388	21,237
Olivia G. Lincoln (43)	1,682,436	6,848,261	17.0913	400,685

²Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as amended (the Code).

multiple used in calculating the exclusion ratio. The balance of the annuity payment is taxable as ordinary income.³ Rev. Rul. 74, *supra*.

³The computations under Rev. Rul. 74, *supra*, can be illustrated by the annuity payable to petitioner Willard W. Garvey as follows (Pet. App. 34a):

Step 1. Compute the exclusion ratio for a male annuitant, age 49, using the expected return multiple from Table I of Treasury Reg. § 1.72-9:

$$2,107,154 \quad = \quad .1594693$$

$$502,416 \times 26.3$$

Step 2. Calculate the annual exclusion:

$$502,416 \times .1594693 \quad = \quad 80,120$$

Step 3. Calculate the gain on the transfer:

Fair market value on June 1, 1969	\$7,628,231
Less: Basis	2,107,154

Total gain	\$5,521,077
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Step 4. Determine ratable share of gain to be recognized each year:

$$5,521,077 \quad = \quad 209,927$$

$$26.3$$

Step 5. Determine ordinary income:

Annuity payment	\$502,416
Less: Annual exclusion	80,120

Balance	422,296
---------	---------

Less: Capital gain recognized	209,927
Ordinary annuity income	\$212,369

After the petitioners filed their returns, they filed timely claims for refund, asserting that the exchange of property for an unsecured private annuity was an "open transaction" within the meaning of *Burnet v. Logan*, 283 U.S. 404 (1931) — because the receipt of each payment was contingent on the survival of the annuitant and on the continuing solvency of the obligor — and hence that the petitioners had no taxable gain from the exchanges until they had fully recovered their respective bases in the property (Pet. App. 37a). The Commissioner disallowed the petitioners' claims for refund, and the petitioners filed suit in the United States Court of Claims (Pet. 3).

2. The Claims Court⁴ rejected petitioners' contention that the open transaction doctrine of *Burnet v. Logan* applies to the taxation of the gain realized on the transfer of property in exchange for a private annuity (Pet. App. 34a-46a). The court pointed out that Congress had revised the statutory scheme in 1954, long after *Burnet v. Logan* was decided. Under Section 72 of the Code, an annuitant's tax burden is spread evenly through his lifetime, instead of subjecting him to a sharp increase in tax liability several years after the annuity starting date, when he recovers his investment in the annuity contract and all subsequent annuity payments become fully taxable (Pet. App. 41a-44a). The court concluded that the provisions of Rev. Rul. 74, which require the petitioners to report the gains realized on the purchase of the private annuities ratably over their life expectancies, are more in keeping with the current statutory scheme of annuity taxation than is petitioners' proposal to defer taxation until they have recovered their respective investments in their annuity contracts (Pet. App. 44a-45a).

⁴The cases were transferred to the Claims Court on October 1, 1982, pursuant to the Federal Courts Improvement Act of 1982, Pub. L. No. 97-164, §§ 402 and 403 96 Stat. 57-58.

3. The court of appeals affirmed. It held that Section 72 displaced the open transaction doctrine in favor of a proration system in the taxation of annuity income, and that the government's method of computation provides an actuarially sound procedure for prorating gain (Pet. App. 8a-9a). The court pointed out (*id.* at 9a) that this method of computation, like the exclusion ratio computation prescribed by Section 72(b), is "based on the rational expectation that over time and throughout the aggregate taxpaying populace individual inequities will average out and the general revenue will be protected."

ARGUMENT

The judgment of the court of appeals is correct. It does not conflict with the decision of this Court in *Burnet v. Logan*, *supra*, or with any decision of any other court of appeals. Accordingly, further review is not warranted.

1. Petitioners contend (Pet. 5-13) that *Burnet v. Logan* requires the government to treat an exchange of appreciated property for a private annuity as an open transaction on which no gain is recognized to the annuitant until he has recovered the full amount of his basis in the property. Petitioners' interpretation of the open transaction doctrine recognized by this Court in *Burnet v. Logan* is erroneous. Nothing in the opinion in that case requires the government to disregard well established principles of actuarial science and treat the exchange of appreciated property for a private annuity as an open transaction, thereby permitting petitioners to enjoy the benefits of a fixed stream of income, while deferring taxation on the exchange for a substantial period of time.⁵

⁵In their brief on appeal (at 32, 34), petitioners stated that they did not dispute the amount of ordinary income they were required to report each year as annuity income under Section 72, nor did they dispute the total amount of capital gain that they would be required to report

In *Burnet v. Logan*, 283 U.S. at 409-410, the taxpayer transferred her interest in an iron mine to a steel company in exchange for a royalty of 60 cents per ton of iron ore extracted from the mine and allocable to her interest. The agreements under which the mine was being operated did not require the purchaser to extract or to pay for any minimum quantity of ore each year, and the amounts actually extracted from the mine varied widely in the years involved. The Court held, 283 U.S. at 413, that the sale of the taxpayer's interest in the mine in exchange for this highly contingent royalty agreement was an open transaction because the royalty payments were "wholly contingent upon facts and circumstances not possible to foretell with

over their life expectancies, as determined pursuant to Section 1.72-9, of the Treasury Regulations on Income Tax. As applied to the annuity payable to petitioner Willard W. Garvey (see note 3, *supra*), it would appear that petitioner Willard Garvey conceded that he was required to report \$212,369 each year as annuity income, and that at the end of his life expectancy of 26.3 years he would have been required to report a total of \$5,521,077 in capital gain (*i.e.*, the fair market value of the property transferred, namely, \$7,628,231, less his basis of \$2,107,154) (Pet. App. 34a). Petitioners contend, however, that instead of reporting this gain pro rata as part of each annuity payment, they are entitled to report only the ordinary income taxable under Section 72, and to receive the remainder of each annuity payment tax free until they have recovered their entire basis in the property (Pet. 3, 5-7). As applied to the annuity payable to Willard Garvey, each annuity payment of \$502,416 would be reduced by ordinary income of \$212,369, leaving a balance of \$290,047 (see note 3, *supra*). Instead of reporting \$209,927 of this amount as capital gain in each year, petitioners contend that Willard Garvey is entitled to receive the entire \$290,047 tax free until the total so received equals his basis of \$2,107,154. By dividing the basis of \$2,107,154 by the annual recovery rate of \$290,047, it appears that petitioner Willard Garvey would obtain a tax deferral of approximately 7.26 years before paying *any* capital gains tax on the purchase of his annuity under the open transaction doctrine. Comparable figures for each of the other petitioners in this case are as follows: Jean K. Garvey, 8.81 years; James S. Garvey, 9.78 years; Shirley F. Garvey, 6.52 years; H. Bernerd Fink, 5.24 years; Ruth G. Fink, 7.04 years; George A. Lincoln, 5.38 years; and Olivia G. Lincoln, 8.75 years.

anything like fair certainty. The promise was in no proper sense equivalent to cash. It had no ascertainable fair market value." As the court of appeals pointed out (Pet. App. 9a), the annuities involved in the present case were totally different. They were payable in a fixed amount each year, contingent only upon the survival of the annuitant and the solvency of the obligor. The possibility of loss through insolvency and default by the obligor is, of course, present to some degree in any deferred payment transaction, but the receipt of notes or other evidences of indebtedness has never been considered, without more, to be a justification for resort to the open transaction doctrine. *Campbell v. United States*, 661 F.2d 209, 215 (Ct. Cl. 1981); *Warren Jones Co. v. Commissioner*, 524 F.2d 788, 793-794 (9th Cir. 1975); *Clodfelter v. Commissioner*, 426 F.2d 1391, 1393-1395 (9th Cir. 1970); *Bruce v. United States*, 254 F. Supp. 816, 818-819 (S.D. Tex. 1966), aff'd, 370 F.2d 569 (5th Cir.), cert. denied, 386 U.S. 1030 (1967).

The uncertainties inherent in the survival of an individual annuitant likewise do not support petitioners' claim that they should be permitted to resort to the open transaction doctrine of *Burnet v. Logan*, in reporting their gains on these private annuities. As the court of appeals pointed out (Pet. App. 9a), the allocation between return of capital and annuity income under Section 72 is based on actuarial proration of each payment and reflects a congressional preference for uniformity of tax liability and prompt collection of the revenue over the "wait and see" approach inherent in the open transaction doctrine. Although Section 72 does not explicitly deal with the tax treatment of gain arising from the purchase of such an annuity, the Claims Court correctly recognized (Pet. App. 44a) that prorating the gain over the petitioners' respective life expectancies is "more in keeping with the statutory scheme" than deferring

capital gains tax altogether until each annuitant has recovered his entire basis in the property transferred in exchange for his annuity.

2. Petitioners rely on the legislative history of the 1954 Code, in particular on the explanation given in H.R. Rep. 1337, 83d Cong., 2d Sess. A26 (1954), for a proposed Section 1241. That provision would have included the value of a private annuity contract in the amount realized on the transfer of property in exchange for such a contract. Hence, petitioners argue that their position is supported by the fact that the Senate Finance Committee deleted the proposed section from the bill, and that later the Conference Committee adopted the Senate version and the House receded from its proposal. S. Rep. 1622, 83d Cong., 2d Sess. 116 (1954); H.R. Conf. Rep. 2543, 83d Cong., 2d Sess. 71 (1954). This reliance is misplaced. As the House Report makes clear, the proposed Section 1241 would have taxed the *entire* amount of the gain to the transferor in the year of sale — a much more drastic acceleration of the recognition of capital gain than the proration required by Rev. Rul. 74. The Senate and the Conference Committee expressed a preference for further study before adopting such a rule. With respect to proration, however, as the Claims Court explained (Pet. App. 42a-44a), the legislative history of Section 72 of the Code shows that Congress was seriously dissatisfied with the “erratic” tax treatment accorded to annuity payments under the 1939 Code and abandoned it in favor of a provision spreading the tax free portion of the annuity evenly over the annuitant’s lifetime. H.R. Rep. 1337, *supra*, at 10, A21; S. Rep. 1622, *supra*, at 10, 171-172. Thus, to the extent that the legislative history of the 1954 Code provides any guidance on the issue in this case it supports our view that the gain should be allocated over the annuitant’s life expectancy; it does not advance petitioners’ claim that they

should enjoy a "tax holiday" lasting from five to nine years while they recover their bases (see notes 3 and 5, *supra*).⁶

3. Finally, petitioners' claim that the Claims Court has misapplied the holding of this Court in *United States v. Davis*, 370 U.S. 65, 71-72 (1962), is without foundation. In *Davis*, this Court rejected the taxpayer's claim that the release of his wife's inchoate marital rights had no ascertainable market value on the ground that the taxpayer had surrendered stock having an ascertainable market value in exchange for the release, and there was a well established principle of law holding that the values of two properties exchanged in an arms-length transaction are presumed to be equal. *Philadelphia Park Amusement Co. v. United States*, 126 F. Supp. 184, 189 (Ct. Cl. 1954). Thus, in *Davis*, the value of the release the taxpayer received in his divorce settlement was held to be equal to the value of the stock he surrendered to obtain that release. Similarly, in the present

⁶Similarly, the decisions of the Tax Court in *Estate of Bell v. Commissioner*, 60 T.C. 469, 474-475 (1973), and *212 Corp. v. Commissioner*, 70 T.C. 788, 802-803 (1978), did not, as petitioners suggest, reject the open transaction doctrine solely on the basis of the fact that, in those cases, the annuities were secured (Pet. 12-13). In both of those cases, the court held that a secured private annuity was property which could be valued according to the Commissioner's annuity tables in Treasury Regulations on Estate Tax § 20.2031-7(f), and that the gain realized on the transfer of appreciated property in exchange for such an annuity was taxable in the year of the transfer. *Estate of Bell*, 60 T.C. at 475; *212 Corp.*, 70 T.C. at 802-803. This latter result was not sought by the Commissioner in those cases and is not consistent with the approach of Rev. Rul. 74, *supra*; and it was this incidental holding, not material here, that provoked the dissents to which the petitioners refer (Pet. 12-13). Indeed, Judge Simpson, in his dissent in *Estate of Bell*, 60 T.C. at 479, characterizes the rule of *Burnet v. Logan*, as "manifestly inconsistent with the objective of section 72," and goes on to suggest a method of proration that would result in the taxation of a portion of the capital gain each year, beginning with the first annuity payment.

case, the Claims Court found that the petitioners had obtained appraisals showing the fair market value of the property they transferred in exchange for their respective private annuities (Pet. App. 34a). The amount of the annuity to be paid to each of the petitioners was derived directly from the appraised fair market value of the transferred property by applying the annuity factors contained in Treasury Regulations on Estate Tax § 20.2031-7(f) (see note 3, *supra*). Thus, the principle announced in *Davis*, that the release should be presumed to be equal in value to the property surrendered in exchange for it, is applicable *a fortiori* to this case where the parties actually used that principle in arriving at an appropriate annuity payment.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

ROX E. LEE

Solicitor General

GLENN L. ARCHER, JR.

Assistant Attorney General

ROBERT A. BERNSTEIN

MICHAEL J. ROACH

Attorneys

AUGUST 1984

Supreme Court, U.S.
FILED

AUG 27 1984

No. 83-1855

ALEXANDER L. STEVAS
CLERK

IN THE
Supreme Court of the United States
OCTOBER TERM, 1984

JAMES S. GARVEY, *et al.*,
Petitioners,
v.

UNITED STATES OF AMERICA,
Respondent.

**On Petition for a Writ of Certiorari to the United States
Court of Appeals for the Federal Circuit**

REPLY BRIEF FOR THE PETITIONER

ERWIN N. GRISWOLD
(Counsel of Record)
MICHAEL C. DURST
JONES, DAY, REAVIS & POGUE
655 15th Street, N.W.,
Suite 600
Washington, D.C. 20005-5701
(202) 879-3898

ROBERT L. HOWARD
FOULSTON, SIEFKIN,
POWERS & EBERHARDT
700 Fourth Financial Center
Wichita, Kansas 67202
Counsel for the Petitioners

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<i>Edgar v. Commissioner</i> , 56 T.C. 717 (1971)	3
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 <i>Statutes</i>	
Internal Revenue Code of 1954, § 72	1, 2, 5, 6
 <i>Other Authorities</i>	
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IN THE
Supreme Court of the United States

OCTOBER TERM, 1984

No. 83-1855

JAMES S. GARVEY, *et al.*,
Petitioners,

v.

UNITED STATES OF AMERICA,
Respondent.

On Petition for a Writ of Certiorari to the United States
Court of Appeals for the Federal Circuit

REPLY BRIEF FOR THE PETITIONER

**I. The Government's Case Depends on Rewriting the
Statute Which Was Written by Congress.**

The only statutory provision which has a bearing on this case is section 72 of the Internal Revenue Code, set out in full at pp. 55a-57a of the Appendix to the Petition.

This statute specifically provides that—

(b) *Exclusion Ratio.* Gross income does not include that part of any amount received as an annuity . . . which bears the same ratio to such amount

as the *investment in the contract* . . . bears to the expected return under the contract.

(Emphasis supplied.)

The phrase "investment in the contract" is then defined in paragraph (c) of the section, as follows:

(1) Investment in the Contract—For purposes of subsection (b), the investment in the contract . . . is—

(a) *the aggregate amount of premiums or other consideration paid for the contract*, minus

(b) the aggregate amount received under the contract

(Emphasis supplied.)

The question of construing the statute as Congress wrote it seems fairly simple and clear. The "investment in the contract" is "the aggregate amount of premiums or other consideration paid." The "consideration paid" in this case was clearly the fair-market value of the property transferred to the annuity-paying corporation. It was *not* the "basis" of that property. Indeed, under the terms of the statute, the "basis" of the "consideration paid" is wholly irrelevant in determining the "exclusion ratio."

As written by Congress, the "exclusion ratio" relates *solely* to the determination of the "interest" element in the annuity payment. Congress made no provision whatever in section 72 with respect to the capital gain involved in the use of appreciated property to pay for the annuity.

This does not mean that the capital gain goes free of tax. On the contrary, that gain is taxable when received—that is, after the taxpayer has recovered his basis. As shown in the petition, this was long the view of the Treasury and of the courts. Indeed, as long as thirty-five years ago, the Third Circuit held this rule was "now well established." *Commissioner v. Kann's Estate*, 174 F.2d

357, 359 (3rd Cir. 1949).¹ There has been no change in the statute since that time as far as capital gain is concerned. There has been a change in the statute with respect to the computation of the "interest element," but the statute which Congress wrote in 1954 does not in any way deal with the computation of capital gain.

Indeed, the Government's whole case turns on its espousal of the reasoning of the Claims Court, that taxation of capital gain before basis is recovered would be "more in keeping with the statutory scheme." Pet. App. 44a, repeated in Br. in Opp. 4. In other words, Congress is to be held to have said something which it did not say. This rewriting of the statute works considerable unfairness on petitioners and others similarly situated.² As this Court has said: "When the profit, if any, is actually realized, the taxpayer will be required to respond." *Burnet v. Logan*, 283 U.S. at 413. The Treasury's action here rewrites the law as written by Congress, and imposes a tax on a gain which may never be realized. It should not be permitted to stand.³

¹ Cf. *Edgar v. Commissioner*, 56 T.C. 717, 742 n.15 (1971): "As a general rule, private annuity agreements, contingent both on the annuitant's lifespan and the obligor's ability to make the payments, do not constitute amounts realized as income within the meaning of sec. 1001(b). See, e.g., *Commissioner v. Kann's Estate*, 174 F.2d 357 (C.A. 3, 1949)."

² The authors of a recent comprehensive study of the taxation of private annuities have written:

The inequity of taxing a "gain" that may never materialize (as where the annuitant dies before recovering the basis of his property exchanged for the annuity) is perhaps the most compelling argument in favor of open transaction treatment.

Warnick, "Private Annuities," 195-3rd Tax Management (BNA), Estates, Gifts & Trusts A-13 (1984).

³ There is a further incongruity in the Government's position, though it is not directly involved in this case. Under Rev. Rul. 74, 1969-1 C.B. 43, the capital gain involved is taxed ratably over the annuitant's life expectancy, even during the period when he cannot

II. Respondent Seeks to Minimize the Conflict Below by Citing Cases Unrelated to the Question Involved Here.

The decision below departs diametrically from other decisions which hold that the realization of capital gain on the purchase of a private annuity is governed by this Court's holding in *Burnet v. Logan*. Pet. 5-11. The weakness of the Government's position is emphasized by its careless use of authorities. It relies (Br. in Opp. 7) on four cases, none of which applies remotely to the income taxation of private annuities.

Three of the cases which respondent cites do not even mention annuities. *Campbell v. United States*, 228 Ct. Cls. 661, 661 F.2d 209 (1981), involved the valuation of restricted securities received on the sale of a family-held corporation. *Warren Jones Co. v. Commissioner*, 524 F.2d 788 (9th Cir. 1975), involved the sale of real property under a deferred-payment contract. *Clodfelter v. Commissioner*, 426 F.2d 1391 (9th Cir. 1970), concerned the receipt of contingent installment payments on the sale of a business. None of these cases would suggest to a reasonable taxpayer that *Evans v. Rothensies*, 114 F.2d 958 (2d Cir. 1940), *Commissioner v. Kann's Estate*, 174 F.2d 357 (3rd Cir. 1949), and the numerous other cases cited in the petition no longer represent the proper application of *Burnet v. Logan* to private annuities.

be sure that he will recover his basis. If he lives beyond his life expectancy (as half, more or less, of all annuitants will), then the Treasury says that the exclusion ratio no longer applies, and that everything received is taxable as ordinary income. There is nothing in the statute which supports this conclusion.

The result is that the Government wins both ways. It gets an unwarranted capital gain tax from the person who does not live long enough to recover his basis. On the other hand, if an annuitant outlives his expectancy, then the continuing gain from the transfer of the consideration for the annuity is taxable as ordinary income, even though the gain, whatever amount it turns out to be, is clearly derived from the transfer of a capital asset.

The fourth case cited by respondent actually *confirms* the application of *Burnet v. Logan* to private annuities. In *Bruce v. United States*, 254 F. Supp. 816 (S.D. Tex. 1966), *aff'd per curiam*, 370 F.2d 569 (5th Cir. 1967), *cert. denied*, 386 U.S. 1030, a taxpayer sought to defer realization of income derived from shares in a petroleum royalty trust until payments from the trust exceeded the taxpayer's basis in his shares. The court denied application of *Burnet v. Logan*, noting that the taxpayer could, at all relevant times, have sold his shares in the over-the-counter market for a price greatly in excess of his basis. The court, however, *distinguished* the royalty from an annuity. It said:

[T]he distinguishing point about an annuity contract is that one never knows if the holder will live long enough to recoup his capital investment. The prospect of receiving income or interest is most uncertain.

254 F. Supp. at 819.⁴ It is difficult to see what comfort respondent derives from *Bruce*. The case simply underscores the departure of the decision below from other decisions governing private annuities.

III. Respondent Seeks to Divert Attention from the Legislative History, Which Makes Plain That Respondent's Position Defies the Intent of Congress.

Twice—first in 1954 and later in 1963—Congress considered, and decided against, overruling *Burnet v. Logan* as it applies to the capital gain element in private annuities. Pet. 13-16. In each instance, legislative history indicates quite plainly that both Congress and the Treasury Department understood that *Burnet v. Logan* remained

⁴ The court noted parenthetically that the Code now requires taxation of certain payments on annuities before basis is recovered. *Id.* This refers, however, to the *interest* element of the annuity, which is taxed under § 72 of the Code, not the capital-gain element which is involved in the present case.

the law applicable to the capital gain element in private annuities. Pet. 14-16. One of these occasions was contemporaneous with the enactment of section 72, and the other was nine years after that enactment. Both expressly recognized the continuing applicability of *Burnet v. Logan* to private annuities.

Respondent now seeks to divert attention from these legislative materials, not by pointing to legislative history to the contrary (of which none is known), but by arguing that the changes which Congress considered in 1954 and 1963 differed from the change which respondent now seeks to impose. The 1954 and 1963 proposals would have required taxation of the total potential gain immediately on the transfer of property for a private annuity, whereas respondent now seeks to require realization of this gain ratably beginning with the first annuity payment. But this distinction is irrelevant to the present question. Respondent's method, like the method which Congress rejected in 1954 and 1963, would require realization and taxation of gain *before the taxpayer's basis has been recovered*. That is why respondent's current position violates *Burnet v. Logan* and its progeny, and that is why Congress in 1954, and Congress and the Treasury in 1963, recognized that the changes then under consideration represented departures from *Burnet v. Logan*. Respondent should not now be permitted to overturn *Burnet v. Logan* where Congress has twice refused to do so.

IV. Respondent Misapplies This Court's Holding in *United States v. Davis*.

Respondent incorrectly seeks support from *United States v. Davis*, 370 U.S. 65 (1962).⁵ As pointed out in the petition, *Davis* and *Burnet v. Logan* involve two entirely distinct questions. *Davis* involves the question of

⁵ The Claims Court (Pet. 40a-41a), but not the court of appeals, makes similarly mistaken use of *Davis*.

how property should be valued after it has been *received* in full. *Logan* involves the question of *when* gain should be recognized, where consideration stated in a contract *may never be received at all*.

CONCLUSION

The opinion of the court below represents an unwarranted departure from the statute, and from plainly stated holdings of other federal courts which apply *Burnet v. Logan* to the taxation of private annuities. The question is a recurring one which ought to be settled, like those in *United States v. Cartwright*, 411 U.S. 546 (1973), or *Dickman v. Commissioner*, 104 Sup. Ct. 1086 (1984).

The petition for certiorari should be granted, and the decision below should be reversed.

Respectfully submitted,

ERWIN N. GRISWOLD
(Counsel of Record)

MICHAEL C. DURST
JONES, DAY, REAVIS & POGUE
655 15th Street, N.W.,
Suite 600
Washington, D.C. 20005-5701
(202) 879-3898

ROBERT L. HOWARD
FOULSTON, SIEFKIN,
POWERS & EBERHARDT
700 Fourth Financial Center
Wichita, Kansas 67202

Counsel for the Petitioners

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